

Terms of Engagement

**A qualitative examination of the basic building blocks of
Australia's international tax regime (residency and source)
against the tax policy objectives of equity, efficiency,
simplicity and the prevention of tax avoidance and an
exploration of the avenues for reform**

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Statement by the Candidate

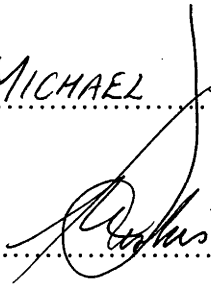
I certify that the thesis entitled *Terms of engagement: A qualitative examination of the basic building blocks of Australia's international tax regime (residency and source) against the tax policy objectives of equity, efficiency, simplicity and the prevention of tax avoidance and an exploration of the avenues for reform*, submitted for the degree of Doctor of Philosophy is the result of my own work and that where reference is made to the work of others, due acknowledgement is given.

I also certify that any material in the thesis which has been accepted for a degree or diploma by any other university or institution is identified in the text.

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Date.....

1 DECEMBER 2004

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Parts of this thesis have been included in articles, conference papers, a report and a law reform submission published, and presented during the candidature.

Note: In joint publications the components of the thesis used is solely the work of the candidate (ie the material was written by myself and extracted from the thesis).

Articles

‘Standing on the outside [not] looking in: International taxation reform outside RITA’ (2004) 7 *Tax Specialist* 231-237

with Brett Bondfield, ‘The RBT ANTS bite: Small business the first casualty’ (2004) 19 *Australian Tax Forum* 101-152

‘Australia's residency rules for companies and partnerships’ (2003) 57 *Bulletin for International Fiscal Documentation* 405-411

‘Reviewing an International Tax Review’ (2002) 6 *Tax Specialist* 68-80

‘Residency: Where we were; Where we are; Where we want to be’ (2001) 5 *Tax Specialist* 66-88

‘Accidents of History: Australia's residency rules for individuals’ (1997) 3 *New Zealand Journal of Taxation Law and Policy* 108-124

Book Chapter

“Residency, source and double taxation” in Michael Kobetsky, Michael Dirkis and Ann O’Connell, *Income Tax: Text, Materials and Essential Cases* (2003, 4th ed), Chapter 6. The Chapter is based upon work in earlier editions in 1997, 1999 and 2001.

Conference/Seminar Papers

‘Overview of Australian International Tax Reform: The Review of International Taxation Arrangements’ (presented to the World Tax Conference, Sydney, 27 February 2004)

with Brett Bondfield, ‘Much ado about nothing - Ralph's consideration of small business’ (presented to the 16th Australasian Tax Teachers Conference, Adelaide, 30 January 2004). Archived at National Library site URL: <http://pandora.nla.gov.au/tep/23524> as at 30 May 2004

‘Reviewing the *Review of International Taxation Arrangements*’ (presented at Taxation Institute of Australia’s International Master Class, Sydney, 14 October 2002)

‘Australia's source rules under review: Change for change sake or needed reform? (A working paper)’ (presented to the 13th Australasian Tax Teachers Conference, ATAX, Sydney, 3 February 2001). Archived at National Library site URL: <http://pandora.nla.gov.au/tep/23524> as at 30 May 2004

‘Corporate residency reform’ (presented to the Taxation Institute of Australia’s Tax Discussion Group No 1, Sydney, 5 July 2000)

‘Residency of companies in Australia: A case for law reform (A working paper)’ (presented to the 12th Australasian Tax Teachers Conference, Melbourne, 5 February 2000). Archived at National Library site URL: <http://pandora.nla.gov.au/tep/23524> as at 30 May 2004

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Law reform submission

The Taxation Institute of Australia’s October 2002 submission No 11 to the Board of Taxation on *Review of International Taxation Arrangements*. Located at URL <http://www.taxboard.gov.au/submissions.asp> as at 30 May 2004

Abstract

The statutory residency rules were introduced in 1930, while some of the statutory source rules have their genesis in the *Income Tax Assessment Act 1936* (Cth), others in the *Income Tax Assessment Act 1915* (Cth) and still others in the 1890s State and New Zealand tax Acts. Similarly the common law principles in respect of residency and source were established in the late 1890's. The fact the law has ancient origins in itself is not the issue, rather it is the ability of that law to engage in a 21st century world where trade in services outstrips trade in goods and the communications revolution has removed the need for traditional physical linkages to jurisdiction.

Concerns about the ability of the law to deal with the Internet lead the ATO, in its 1997 Report on Taxation and the Internet to call for the current source, residency, and permanent establishment rules to be substantially revised. Similarly, the 1999 broad inquiry into Australia's business tax regime by the Review of Business Taxation recommended reform of the source "rules", while the 2003 Board of Taxation report (in respect Treasury's *Review of International Taxation Arrangements*) recommended reform of the company residency test.

These calls for change have been initiated without a contemporary, comprehensive review of the rules against tax policy objectives. This thesis undertakes that study.

The thesis argues that the law of residency and determination of source under Australia's income tax law (the *Income Tax Assessment Act 1997* (Cth)) is inadequate in its practical application when judged against four tax policy objectives; equity, efficiency, simplicity and the prevention of tax avoidance. It establishes that the residency rules (applicable to individuals, companies and trusts) and that the determinations of source income do not meet those objectives (particularly in respect of simplicity and the prevention of avoidance).

The thesis also argues that there is scope to modify the law, within the jurisdictional framework, so that it more closely meets the tax policy objectives. A comparative study of residency and source in other jurisdictions is undertaken to explore the potential alternatives for reform.

Although the thesis identifies limited areas where change, consistent with the tax policy objectives and within the jurisdictional boundaries, is achievable, it concludes that significant change is not possible without reconsidering Australia's jurisdictional claim.

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List of Acronyms

ATO	Australian Taxation Office
CGT	capital gains tax
DTAs	double tax agreements
CGT	capital gains tax
CFC	controlled foreign company
FIF	foreign income fund
FBT	fringe benefits tax
FSI	foreign source income
GST	goods and services tax
OECD	Organisation for Economic Cooperation and Development
OECD Model Convention	OECD, <i>Model Tax Convention on Income and Capital</i> (2003)
OPC	Office of Parliamentary Council
PAYG	pay as you go
1915 Act	<i>Income Tax Assessment Act 1915</i> (Cth)
1922 Act	<i>Income Tax Assessment Act 1922</i> (Cth)
1936 Act	<i>Income Tax Assessment Act 1936</i> (Cth)
1997 Act	<i>Income Tax Assessment Act 1997</i> (Cth)

Chapter 1

Introduction

The primary objective of this thesis is to examine and assess the adequacy of residency and source (the so-called the “rules of attachment”) used in determining sufficient connection under the Australian income tax law. This examination is to be undertaken against the tax policy objectives of equity, efficiency, simplicity and the prevention of tax avoidance.¹ A second objective, having evaluated and defined the adequacy of these rules, is to examine the avenues for reform that more closely satisfy the objectives just noted.

This chapter provides an introduction to the thesis by illustrating the importance of residency and source in the Australian income tax law. It does this against a contextual summary of the historical transition in Australia from a territorial (source) based system of taxation to a worldwide (residency) based system of taxation in the context of Colonial, State and Commonwealth income tax law. Having clearly articulated the thesis and the reasons that justify testing of the thesis, the Chapter also lays out the approach to be adopted in exploring the thesis.

I. Background

While in theory public international law does not impose any limitations on a government's power to tax,² it is widely accepted that a government's power is effectively limited to those taxpayers who have a “sufficient connection” to the jurisdiction.³ Sufficient connection can be established in five ways:⁴

1 The appropriateness to the tax policy objectives selected is argued in Chapter 2.

2 See the United States Supreme Court decision in *McCullock v Maryland*, 4 Wheaton 316, 429 (1819) and Martin Norr, ‘Jurisdiction to Tax and International Income’ [1962] *Tax Law Review* 43.

3 Similarly, the Commonwealth, Royal Commission on Taxation, *Reports* (1932-34) (the 1932 Royal Commission), 65 noted that “[e]very state has an unrestricted right to adopt its own methods of taxation within the sphere of its jurisdiction. The obligation or duty to pay taxes may be determined by reference to various tests, as, for example, political allegiance, temporary residence, domicile or origin.” Other attachment rules used to justify the right to tax include sovereignty, benefit/entitlement, faculty, economic allegiance and realistic doctrines – see Niv Tadmor, *Tax Treaties and Electronic Commerce* (SJD Thesis, Deakin University School of Law, 2003), 15-40.

4 Edwin R A Seligman, *Essays in Taxation* (3rd ed, 1900), 108.

- political allegiance (ie citizenship) of the taxpayer (the oldest principle);⁵
- temporary residence of the taxpayer;⁶
- residency or domicile of the taxpayer (the world-wide principle of taxation);⁷
- taxation based on where the property is located or where the income is sourced (the territorial principle of taxation);⁸ and
- the economic interest or economic allegiance of the taxpayer, ie taxed according to an individual's economic interests under each jurisdiction.⁹

Of these five possible badges of sufficient connection, Australia adopts two,¹⁰ the source of the receipt (the territorial principle of taxation) and the residency or domicile of the taxpayer (the world-wide principle of taxation). Both source and residency are based strongly upon geographical attachment (ie either by the taxpayer being located within the jurisdiction or by a transaction being conducted within the jurisdiction).

However, despite the importance of each principle, both principles remain vague and ill-defined. For example, in law there is no single concept of "residence".¹¹ The term residence can have a different meaning in different contexts (eg its meaning in jurisdictional matters will vary from its meaning in an income tax context). Even in the revenue context, the term's meaning can vary.¹²

Despite the variety of definitions, a good starting point adopted by the courts for obtaining a general sense of the term is the dictionary meanings of the word (ie "reside"

5 Ibid. However, Seligman rejects this test as "[i]n the modern age of the international migration of persons as well as capital, political allegiance no longer forms an adequate test of individual fiscal obligation. It is fast breaking down in practice, and it is clearly insufficient in theory" (at 109).

6 Ibid. Although Seligman (at 109) rejects this test as not having any logical basis (ie the "... relations between him and the government are too slight"), the operation of this approach can be seen in indirect taxes like Goods and Services Taxes (GSTs) and Value Added Taxes (VATs), and in accommodation or entertainment levies.

7 Ibid. This later basis of taxation is based on the concept that personalty (property) of the income follows the owner (*mobilia personam sequuntur*). The principle is sometimes expressed as *mobilia inherent ossibus domini* (at 112).

8 Ibid. The doctrine of *situs*, ie taxed where the property is located or where the income is sourced (the territorial principle of taxation).

9 1932 Royal Commission, above n 3, 65 and Klaus Vogel, 'Worldwide vs source of income – A review and revaluation of arguments (Part I)' (1988) 8-9 *Intertax* 216, 219.

10 1932 Royal Commission, Ibid.

11 Peter E Nygh, *Conflicts of Laws in Australia* (3rd ed, 1976) 145. See also R Sappideen, 'The residence of natural persons' (1979) 8 *Australian Tax Review* 139.

12 See, eg, *Income Tax Assessment Act 1936* (Cth) (the 1936 Act) s 23AA (the term "ordinarily resident" is used), cf *Income Tax Rates Act 1986* (Cth) (the term "resident taxpayer" is used).

means ". . . to dwell permanently or for a considerable time, to have one's settled or usual abode, to live, in or at a particular place").¹³

There are also three general usages of the term "source" in taxation law. The principal usage of the word "source" is the concept of "territorial" source; being the place the income arises. The two other uses of the term "source" are in the context of the taxing of income as it arises (ie taxing income "at its source"), and to describe the "character" of the receipt (ie the classification of receipts according to the nature of the activity that gave rise to the receipt, for example "income from business"). Although the "characterisation" of income is an important issue, the focus of this work will be on territorial source.¹⁴

A. Importance of sufficient connection

Despite being ill-defined the sufficient connection principles of source and residency are the so-called "fundamental building blocks" of the Australian taxation system.¹⁵ Under the *Income Tax Assessment Act 1997* (1997 Act) a finding of residency is the primary way income is tied to the Australian¹⁶ tax system. Residents are assessed on their

13 *Applegate v Federal Commissioner of Taxation* (1979) 9 ATR 899, 905; 79 ATC 4307, 4313, per Northrop J relying on the *Shorter English Oxford Dictionary*. The *Macquarie Concise Dictionary* (3rd ed, 1998), 987 defines resides in similar terms - "to dwell permanently or for a considerable time; have one's abode for a time". Justice Wilcox in *Hafza v Director-General of Social Security* (1985) 6 FCR 444, 449 stated "[t]here is a plethora of decisions arising in various contexts . . . relating to the legal concept of residence. As a general concept residence includes two elements, physical presence in a particular place and intention to treat that place as home at least for the time being not necessarily forever."

14 Characterisation is important in a number of areas including income/capital determinations and in determining the nature of a receipt (such as a royalty) for the purpose of Australia's bilateral agreements for the avoidance of double tax and the prevention of fiscal evasion with respect to taxes on income (DTA's), which are located as Schedules to the *International Tax Agreements Act 1953* (Cth). The importance of this issue is recognised by the Australian Taxation Office (*Taxation and the Internet: Second Report* (1999) para 5.2.9) and by the OECD (which created a dedicated Technical Advisory Group on Treaty Characterisation of E-Commerce Payments). For further discussion see Chapter 5 Part II A of the thesis.

15 See eg Robin H Woellner, et al, *Australian Taxation Law* (13th ed, 2003), 1348.

16 The definition of "Australia" in s 6(1) of the 1936 Act was repealed in 1960. The operative definition is found in the *Acts Interpretation Act 1901* (Cth) and applies to all Commonwealth Acts, unless a contrary intention appears. Under s 17(a) "Australia" or "the Commonwealth" means the Commonwealth of Australia and, when used in a geographical sense, does not include an external Territory. The following subsections further refine the definition:

17(p) "Territory of the Commonwealth" or "Territory under the authority of the Commonwealth" includes any Territory administered by the Commonwealth under a Trusteeship Agreement;

(pa) "Territory" or "'Territory of Australia" means a Territory referred to in s 122 of the Constitution, and includes a Territory administered by the Commonwealth under a Trusteeship Agreement; . . .

(pd) "External Territory" means a Territory, not being an internal Territory, for the government of which as a Territory provision is made by any Act;

ordinary¹⁷ and statutory¹⁸ income from all sources under the 1997 Act. A finding that a taxpayer is not a resident of Australia (a non-resident)¹⁹ will limit the income subject to tax in Australia to the ordinary²⁰ and statutory²¹ income from Australian sources. A determination of residency is also crucial for corporate group consolidation,²² the taxation of income from trusts,²³ entitlement to oral binding rulings,²⁴ entitlement to tax offsets (rebates)²⁵ and the taxation²⁶ and regulation²⁷ of superannuation. Source is

(pe) "Internal Territory" means the Australian Capital Territory, the Jervis Bay Territory or the Northern Territory.

The definition of "Australia" is extended to the Territories for the purposes of s 23AA of the 1936 Act. The scope of the 1936 Act is further extended beyond the "Australia" definition by two other sections. These extensions include certain sea installations (vessels and oil rigs) and offshore areas (including the external territories of Ashmore and Cartier Islands, the Coral Sea Islands and Heard and McDonald Islands and Petroleum Act adjacent areas) (s 6AA), and, to limited extent, to Territories of the Cocos (Keeling) Islands, Christmas Island and Norfolk Island (s 7A).

17 s 6-5 (2) [Assessable ordinary income - residents] If you are an Australian resident, your assessable income includes the *ordinary income you *derived directly or indirectly from all sources, whether in or out of Australia, during the income year.

18 s 6-10 (4) [Assessable statutory income - residents] If you are an Australian resident, your assessable income includes your *statutory income from all sources, whether in or out of Australia.

19 The definition of a "non-resident" in s 6(1) of the 1936 Act, unlike the resident definitions was not initially incorporated into the *Income Tax Assessment Act 1997* (Cth) (the 1997 Act). The definition continues to be operative for the 1936 Act. However, the definition was subsequently placed in s 995-1 of the 1997 Act by *A New Tax System (Pay As You Go) Act 1999* (Cth) under the guise of a new definition of "foreign resident" (ie, a person who is not a resident of Australia for the purposes of the 1936 Act) to facilitate the PAYG provisions relating to dividends, interest and royalties received in Australia. The term "foreign resident" is also used in the *Taxation Administration Act 1953* (Cth) ss 12-315 and 12-317 and was also used in Board of Taxation, Commonwealth, *Tax Value Method Demonstration Legislation Prototype 4* (2002) s 995-1. A specific non-residency definition (ie "non-resident life assurance policy") was introduced by *New Business Tax System (Miscellaneous) Act (No 2) 2000* (Cth) to define the exempt income of insurance companies.

20 s 6-5 (3) [Assessable ordinary income - non-residents] If you are not an Australian resident, your assessable income includes:

- (a) the *ordinary income you *derived directly or indirectly from all *Australian sources during the income year; and
- (b) other *ordinary income that a provision includes in your assessable income for the income year on some basis other than having an *Australian source.

21 s 6-10 (5) [Assessable statutory income - non-residents] If you are not an Australian resident, your assessable income includes:

- (a) your *statutory income from all *Australian sources; and
- (b) other *statutory income that a provision includes in your assessable income on some basis other than having an *Australian source.

22 The residency of an entity is crucial for an entity's inclusion in a consolidated group – see, eg, 1997 Act ss 700-5(2) (general), 703-1 and 703-15 (companies), 703-25 (trusts), and 719-10 to 719-20 (multiple entry consolidated (MEC) groups).

23 The categorisation as a resident or a non-resident trust estate is important for the purposes of applying ss 99 and 99A of the 1936 Act, in that if it is a resident trust estate all net income regardless of its source will be subject to tax in Australia if it is income to which no beneficiary is presently entitled. In contrast, if it is a non-resident trust estate, it is only that part of the income to which no beneficiary is presently entitled that also has an Australian source that will be subject to tax in Australia. Also, beneficiaries in non-resident trusts (see definition in s 95(3) of the 1936 Act) are subjected to the foreign income fund measures (FIF) and transferor trust measures.

24 *Taxation Administration Act 1953* (Cth) s 360-140(1)(a) of Schedule 1: the Commissioner is not permitted to provide an oral binding ruling on a matter of law if during the inquiry period the Commissioner is not satisfied that the person making the request was an Australian resident.

25 See, eg, baby bonus in 1936 Act ss 61-355, 61-360. Entitlement to a tax rebate (a baby bonus) upon birth or adoption of your "first" child (a "child event") required the parent to be a resident. The

crucial in determining whether income is tax exempt,²⁸ determining timing of assessment,²⁹ whether losses will be quarantined³⁰ and availability of tax credits.³¹

Specifically, for international transactions a finding of Australian residency or determining an Australian source for income of a non-resident will render that taxpayer subject to Australian tax. For example, under the *Income Tax Assessment Act 1936* (1936 Act), where an Australian resident derives income sourced outside Australia the foreign tax credit system allows both direct and indirect (or underlying) credits in respect of foreign tax paid, as well as a series of exemptions.³² Exemptions in respect of the foreign source income of residents also exist where the Government has sought to fill skill shortages by encouraging foreign experts to come to Australia for limited periods.³³ There is also a system for allowing deductions for current and carried forward foreign losses.³⁴ Further, where residents have interests in offshore companies they then may be subject to the Controlled Foreign Company (CFC) or Foreign Income Fund (FIF) measures. Similarly, interests in trusts may subject them to the transferor trust measures and the FIF measures. There are also special rules for companies engaged in offshore banking and those that establish regional headquarters in Australia.³⁵

scheme for new parents was terminated from 1 July 2004, but current participants continue to receive their entitlement until 30 June 2009.

26 *Taxation Administration Act 1953* (Cth) s 360-140(1)(a).

27 See, eg, *Superannuation Guarantee (Administration) Act 1996* (Cth) s 27.

28 See, eg, the 1936 Act s 23(r) (via the operation of ss 6-20 and 11-15 of the 1997 Act), which excludes from the scope of the 1997 Act the foreign source income of non-resident taxpayers, except where a provision of the 1997 Act expressly includes assessable income on a basis other than source. See also, eg, the 1936 Act s 23AG, which applies foreign service income of residents.

29 See the transferor trust (1936 Act Division 6AAA of Part III), CFC (1936 Act Part X) and the FIF measures (1936 Act Part XI).

30 See foreign tax loss measures (1997 Act Division 36 and 1936 Act ss 79D, 79DA, and 160AFD).

31 See the foreign tax credit system, Division 18 of Part III of the 1936 Act.

32 See generally 1936 Act, Division 18. These exemptions apply where the foreign income received has previously been subject to Australian tax (eg ss 1936 Act ss 23AI and 23AK) or where it is administratively easier to exclude the income. An example of the latter is s 23AG of the 1936 Act, which provides an exemption from tax for salary and wage income where a resident has been engaged in continuous foreign service for at least 91 days.

33 See, eg, 1936 Act s 517 (exemption from the FIF rules for individuals who enter Australia on a temporary entry permit, where the visa is for four or fewer years' duration) and 1997 Act s 104-165(1) (exemption from capital gains tax, provided the individual was an Australian resident for less than 5 years of the last 10 years and the asset disposed of was either owned by taxpayer before becoming a resident or it was acquired after becoming a resident because of someone's death).

There were proposals made by Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999) to extend these limited exemptions but following two failed attempts to introduce the proposed changes (*Taxation Laws Amendment (No 4) Bill 2002* (Cth) (introduced on 30 May 2002) and *Taxation Laws Amendment Bill (No 7) 2002* (Cth) (introduced on 23 October 2002)) due to the opposition parties in the Senate opposing the bills passage, the Government has abandoned the reform proposals – Treasurer, 'Taxation of temporary residents' (Press Release No 105, 8 December 2003).

34 See, eg, 1936 Act ss 79D, 79DA, 79E and 160AFD.

35 1936 Act Div 9A.

Non-residents are also subject to a range of special rules. Non-residents have a zero tax-free threshold³⁶ and are excluded from personal tax offsets.³⁷ However, interest, dividend and royalty income derived by non-Australian residents is subject to withholding taxes at rates lower than that applicable to residents.³⁸ Under the rewritten rules contained in Div 820 of the 1997 Act (formerly Div 16F of the 1936 Act) non-residents with investments in Australia and residents with outbound investments may be subject to thin capitalisation rules (which impose limits on debt/equity ratios on both forms of investment). Division 13 of the 1936 Act may also apply to set aside or vary transactions that have the effect of shifting profits (transfer pricing arrangements).

The above discussion illustrates that Australia's ability to regulate international tax matters is reliant on the law relating to the fundamental building blocks of residency and source.³⁹ The adequacy of that regulation must be questioned if it is proved that in essence the concepts of residency and source are vague and ill-defined.

B. History of residency and source

The reasons for the lack of clarity of these rules of attachment may be explained by the fact that the rules have not always operated in tandem in Australia. Although a world wide basis (extra territorial) of taxation was adopted in Australia's first colonial income tax law,⁴⁰ the income tax systems introduced by the Commonwealth of Australia and the other Australian States/Colonies were founded on source rather than residency.⁴¹ This

36 *Income Tax Rates Act 1986* (Cth) ss 12, 15, 18 and Schedules 7, 10 to 12.

37 Concessional rebates – see, eg, 1936 Act s 159H(1).

38 1936 Act Divs 11A and 13A.

39 Roger Hamilton, Robert Deutsch and John Raneri, *Australian International Taxation* (October 2002), para 2.10. It follows that understanding of the principles of residency and source is necessary for anyone who practices income tax - Justice D Graham Hill, 'Contemporary tax practice' (Paper presented at the 14th Australasian Tax Teachers Association Conference, Auckland, 18 January 2002) 4.

40 Introduced in Tasmania in 1880 by the *Real and Personal Estates Duty Act 1880* (Tas).

41 James Gilbert, *The Tax Systems of Australasia* (1943) 39, and in Commonwealth, Royal Commission on Taxation, *Reports* (1920-24) (the 1920 Royal Commission) Jolly stated at 138A that "... in the taxing Acts of the Commonwealth and the States of Australia, as in other important parts of the British Dominions, the scope of the income tax has always been confined to incomes derived from a source within the geographical area controlled by the taxing authority." However, these observations are not correct, as Tasmania adopted a worldwide basis for taxing income. The *Real and Personal Estates Duty Act 1880* (Tas) s III imposed a tax on "all dividends declared, or ascertained, or becoming due from any Company carrying on business in Tasmania". This residency approach was continued in Tasmania's first general income tax Act, the *Income Tax Act 1894* (Tas) s 14 which imposed a "... tax on all Income arising, accruing, received in, or derived from Tasmania", and continued in all subsequent Acts (eg *Income Tax Act 1902* (Tas) s 14, and *Land and Income Taxation Act 1910* (Tas) s 27). In all of these Acts relief from any potential double taxation was provided for by permitting any taxpayer residing in Tasmania in receipt of

occurred despite the English income tax legislation from its origins in 1799 adopted a residency basis for taxation⁴² and the majority of the colonies/dominions of the British Empire (including Canada, New Zealand and India) followed suit by adopting a residency or a domicile basis of taxation. However, the Australian Colonies were not alone as a number of other colonies/dominions adopted a source basis.⁴³

This dominance of source as the primary method for determining liability for income tax in Australia⁴⁴ came to an end in 1930 when the Commonwealth⁴⁵ and some states⁴⁶ introduced the residency basis of taxation. This change had its genesis in the recommendations of the 1920 Royal Commission on Taxation,⁴⁷ and was accepted by the Commonwealth Parliament in 1927.⁴⁸ By the introduction of uniform income tax legislation between 1936 and 1937,⁴⁹ income tax levied in Australia moved from this territorial (source) principle of taxation to a worldwide principle of taxation based upon the residency of a taxpayer. However, uniformity in the definition of residency between

foreign source income, to deduct from the income tax payable in Tasmania any income tax paid in respect of that foreign income derived in England or elsewhere (eg 1894 Act s 29, 1902 Act s 52 and 1910 Act s 114).

- 42 *Income Tax Act 1799* (UK) - see Denis Sheridan, 'Residence in the United Kingdom: Observations on the Inland Revenue Consultative Document' (1989) 29 *European Taxation* 17, 18.
For a more detailed history of the development of taxation laws see James Coffield, *A Popular History of Taxation from Ancient to Modern Times* (1970); B E V Sabine, *A History of Income Tax* (1966); and B E V Sabine, *A Short History of Taxation* (1980). From an Australian perspective see Peter Harris, *Metamorphosis of the Australasian Income Tax: 1866 to 1922* Research Study No 37, Australian Tax Research Foundation (2002); Julie Smith, *Taxing Popularity: The Story of Taxation in Australia* (1993); Ian vanden Driesen and Richard Fayle, 'History of Income Tax in Australia' in Richard Krever (ed), *Australian Taxation: Principles and Practice* (1987) 27-36; and Stephen Mills, *Taxation in Australia* (1925).
- 43 For example, the Union of South Africa, Southern Rhodesia, Northern Rhodesia and Basutoland. Although countries such as Singapore continue to tax on a source basis, other traditionally source taxing countries are converting to a residency basis (eg South Africa changed from 1 January 2001).
- 44 1920 Royal Commission, above n 41, Appendix No 6. Norman Rydge in *The Law of Income Tax in New South Wales* (1921) 41 and *Federal Income Tax Law* (1921) 60 noted, relying on *Commissioner of Taxation (NSW) v Kirk* (1900) AC 588; 21 NSWLR 154, that it is immaterial whether a person resides in New South Wales or in Australia as residency is not relevant determining tax liability.
- 45 A definition of "resident", similar to the current "resident" definition in s 6(1) of the 1936 Act, was introduced via s 2(i) of the *Income Tax Assessment Act 1930* (Cth).
- 46 Although the source basis of taxation continued for all States (except for Tasmania), residency based taxation was adopted in respect of specific categories of income. For example, a residency basis of taxation of dividends was introduced in South Australia via s 4 of the *Taxation Act 1931* (SA), and ex-Australian income was partially taxed in New South Wales (income from non-investment trade or business) and Western Australia (export income).
- 47 1920 Royal Commission, above n 41, 108.
- 48 Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4845 (Dr Earle Page).
- 49 1936 Act (Cth); *Income Tax (Management) Act 1936* (NSW); *Income Tax (Assessment) Act 1936* (Vic); *Income Tax Assessment Act of 1936* (Qld); *Income Tax Assessment Act 1936* (SA); *Land and Income Taxation Act 1910* (Tas) as amended by *Land and Income Taxation Act 1935* (Tas); and *Income Tax Assessment Act 1937* (WA).

States and the Commonwealth⁵⁰ was only ensured in 1942 with the Commonwealth passing four Acts, which centralised the levying of income taxation in the hands of the Commonwealth.⁵¹ Since 1939, when the so-called "superannuation" test was introduced, the definition of "resident" in s 6(1) of the 1936 Act (which is the definition adopted for the 1997 Act via s 995-1) has not been substantially amended.⁵²

Over the period statutory source deeming rules have been introduced on an ad hoc basis not governed by any general principles. Except for the royalty source deeming rules,⁵³ which were introduced in 1968 and 1986, the genesis of many of these rules is the *Income Tax Assessment Act 1922* (1922 Act), and in some cases, the *Income Tax Assessment Act 1915* (1915 Act) and earlier State Acts.⁵⁴

50 For example, in respect of residency of individuals New South Wales, in the *Income Tax (Management) Act 1936* (NSW) s 5(a), adopted the "resident person" definition used in the *Income Tax (Management) Act 1928* (NSW) s 3. Section 5(a) defines "resident" to mean "a person, other than a company, whose usual or principal place of abode is in his State and includes any such person who is a public officer of the Commonwealth or of this State and who is absent from this State in the performance of his duty, and the wife of such public officer absent from this State with him." Tasmania, in the *Land and Income Taxation Act 1910* (Tas) s 2(1) adopted only the "resides" test. Similarly, Queensland reserved the additional power for the Commissioner to deem a company to be resident (*Income Tax Assessment Act of 1936* (Qld) s 4) while Tasmania deemed company residence to be "... the place where the company has - I. Either its head office or its chief place of business: or II. Its chief place of manufacture or production within the Commonwealth" (*Land and Income Taxation Act 1910* (Tas) s 2(1)).

51 The four Acts which centralised income taxation in the Commonwealth were the *States Grants (Income Tax Reimbursement) Act 1942* (Cth) which provided for payments to the states, *Income Tax (War-time Arrangements) Act 1942* (Cth) which provided for the transfer of state officers to the Commonwealth, *Income Tax Assessment Act 1942* (Cth) which gave payment of Commonwealth income tax priority over all other taxes, and *Income Tax Act 1942* (Cth) which imposed new tax rates for the year. With the validity of these laws upheld by the High Court in *State of South Australia v Commonwealth* ('First Uniform Tax Case') (1942) 65 CLR 373, the States suspended the operation of their income tax legislation – see *Income Tax Suspension Act 1942* (NSW) ss 2 to 7; *Financial Arrangements and Development Aid Act 1942* (Qld) ss 3 to 6; *Income Tax Suspension Act 1942* (SA) ss 5 and 6; *Land and Income Tax Act (No 2) 1942* (Tas) s 3(1); *Income Tax (War-time Collections) Act 1942* (Vic) ss 2 and 3; and *Income and Entertainments Tax (War-time Suspension) Act 1942* (WA) ss 2 and 3. The operation of the tax laws in Western Australia was suspended indefinitely by the *Income and Entertainments Tax (War-time Suspension) Act 1953* (WA) s 3.

52 Section 6(a)(iii) was added by the *Income Tax Assessment Act 1939* (Cth). The subsequent changes to the definition only reflect changes to the Commonwealth's superannuation scheme named in s 6(a)(iii).

53 These rules deem an Australian source for certain royalty payments (s 6C of 1936 Act inserted by *Income Tax Assessment Act 1968* (Cth)) and certain natural resource payments (s 6CA of 1936 Act inserted by *Taxation Laws Amendment Act (No 4) 1986* (Cth)).

54 For example the ship charterer source rules were introduced into New South Wales in 1895 by s 24 of *The Land and Income Taxation Assessment Act 1895* (NSW) and in Victoria in 1896 by s 18 of the *Income Tax Act 1896* (Vic).

II. Justification

There are two primary reasons for undertaking this study: the lack of formal review of the laws dealing with residency and source despite great changes in the tax landscape and the Australian economy, and a specific gap in the government and academic literature.

A. A lack of formal review

First, although a determination of residency and/or source is a crucial part of any tax system, the development of these legal concepts lies principally in the 19th and early 20th century common law and in statutory developments in the mid 1890's through to the 1930s. The residency rules were adopted at a time when "... there were virtually no Australian taxpayers who received an income from investments or business abroad," and as a result Australia did not have a single bilateral tax treaty from the prevention of double taxation and tax avoidance (so-called Double Tax Agreements (DTAs)).⁵⁵

Despite developments in Australia's economy since 1930 and subsequent Royal Commissions and Inquiries over the last sixty years into the Australian tax system there has been no fundamental change to laws dealing with residency and source. The Asprey Committee in 1975 found, based upon considerations of equity and efficiency, that there was "a case for extending the exercise of jurisdiction to tax on the basis of residence so that all foreign income is subject to Australian tax and credit, so far as administratively feasible."⁵⁶ Despite that recommendation no reform eventuated.

Since the 1980's Australia has been further thrust into the international market place. There was wide recognition that the Australian taxation system did not possess a cohesive legislative framework to deal effectively with the demands of both Australian businesses in the international market place and with foreign businesses operating in

55 Edwin RA Seligman, *Double Taxation and International Fiscal Cooperation* (1928), 47. Australia's first DTA was signed with the United Kingdom on 29 October 1946 and incorporated into the Third Schedule of 1936 Act by *Income Tax Assessment Act 1947* (Cth). With the signing of a second DTA with the United States on 14 May 1953, both DTAs were placed in the schedules to the *Income Tax (International Agreements) Act 1953* (Cth).

56 Taxation Review Committee, Commonwealth, *Full Report* (1975) 260 (Asprey Report). The Committee (in Chapter 17A) recommended the adoption of specified statutory source rules dealing with income from personal service, income from business, and interest, dividend and royalty income.

Australia.⁵⁷ The level of weakness in the tax system is illustrated by the fact that as late as 1985 much foreign source income was either not taxed or taxed lightly.⁵⁸ In addition, the liberalisation of exchange controls in 1983 created opportunities for tax avoidance and tax minimisation by the use of tax havens.⁵⁹

In light of these concerns, many aspects of the taxation of international transactions have been subjected to change since 1985. This process started in 1986 with the introduction of a foreign tax credit system.⁶⁰ In the following years the tax law has been further amended to introduce the foreign source income (FSI) measures,⁶¹ the FIF measures,⁶² revised withholding tax collection procedures in respect of royalties paid to non-residents⁶³ and new rules in respect of the taxation of offshore banking units (OBUs).⁶⁴ As well as these amendments to the 1936 Act, Australia entered into, or renegotiated, many of its comprehensive bilateral tax agreements. However, these reforms were aimed at addressing specific weaknesses in the existing rules (such as bringing forward the timing for recognition of offshore income (FSI and FIF measures) or providing incentives for foreign investors (eg OBUs)), not at revising fundamental rules like residency and source.

The failure to address fundamental reform has continued despite a number of recent Government initiated reviews of aspects of the tax system. The 1999 broad inquiry into Australia's business tax regime by the Review of Business Taxation failed to address the

57 For example see the Office of the Economic Planning Advisory Council, Commonwealth, *An Overview of Submissions Received on Taxation Reform* (1985)) and its findings - Commonwealth, *Reform of the Australian Tax System: Draft White Paper* (1985). The Draft White Paper set out the Government's reform agenda including measures aimed at reforming the international tax regime. In July 1985 the Hawke Government held a Tax Summit (recommendations of which were summarised in Commonwealth, *A Guide to Tax Reform* (1985)). As a result of the Summit the then Treasurer, Paul Keating (in his 19 September 1985 *Reform of the Australian Taxation System: Statement by the Treasurer* (1985)) announced a number of major reforms including the introduction of a foreign tax credit system.

58 Allen Boxer, 'Tax Reform Revisited' (1985) 2 *Australian Tax Forum* 363, 373 and Richard Fayle, 'Controlling Abusive Tax Shelters' (1985) 2 *Australian Tax Forum* 53, 64.

59 The then tax clearance procedures under Part IV of the *Taxation Administration Act 1953* (Cth) did not permit the issue of a tax clearance where tax havens were the destination of the funds. Section 39B of the *Banking Act 1959* (Cth) did not allow the Reserve Bank to permit specified funds transfers without such a certificate. By removing these procedures funds could flow into tax havens. See generally John Azzi, 'Historical development of Australia's international tax rules' (1994) 19 *Melbourne University Law Review* 793, 803 and *ibid* Fayle (1985) 64.

60 Above n 31.

61 Above n 29.

62 *Ibid*.

63 Amending the definition in s 6 and Division 4 of Part IV of the 1936 Act introduced by the *Taxation Laws Amendment Act (No 5) 1992* (Cth).

64 Division 9A of Part III of the 1936 Act introduced by the *Taxation Laws Amendment Act (No 4) 1992* (Cth).

area of residency and only made a number of superficial recommendations to reform the existing source “rules”.⁶⁵ The Government on 11 November 1999 accepted the source rule recommendations in principle,⁶⁶ subject to further development through consultation. Changes to the residency definition were also mooted in other proposed reform measures.⁶⁷

On 22 August 2002 the Treasury in a consultative paper titled *Review of International Taxation Arrangements* (the Consultation paper)⁶⁸ also considered options for reforming the company residency test,⁶⁹ the treatment of dual residents and the taxation of expatriates. However, it did not pick up on the Review of Business Taxation recommendation in respect of reforming the statutory source rule. Despite the Board of Taxation in *International Taxation: A Report to the Treasurer* recommending the adoption of “incorporation” as the sole test for corporate residency,⁷⁰ the Government

65 A Tax System Redesigned, above n 33, Recommendation 23.2(c), 684. Recommendations were also made in respect of the taxation of non-residents and double tax agreements - Recommendations 22.17 to 22.24 and 23.1 to 23.3. Anne O’Connell, ‘The race for tax base: Allocation of taxing rights between source and residence jurisdictions in Australia’ (2001) 24 *Tax Notes International* 1003, 1005 n 23 and Hamilton, above n 39, para 2.300 claim that in 1985 the Government indicated source rules were being developed. However, the reference upon which they rely in Paul Keating, Commonwealth, *Reform of the Australian Taxation System: Statement by the Treasurer* (1985) 66 seems to be limited to source in the context of availability of a foreign tax credit rather than the distillation of the existing territorial source rules into statutory source rules.

66 Treasurer, ‘The New Business Tax System: Stage 2 Response’ (Press Release No 74, 11 November 1999) Attachment N.

67 In Explanatory Materials, Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000 (Cth) para 1.40 the Government indicated that modifications of the residency test for non-fixed trusts were being developed. Similarly, the Board of Taxation had flagged further changes to the residency definition under the then proposed Tax Value Method (TVM) (see Board of Taxation, Commonwealth, *Tax Value Method Demonstration Legislation Prototype 4* (2002) ss 4-15 and 995-1). TVM was designed to replace Australia’s current traditional income tax system (ie based upon the income/capital dichotomy) with a new income calculation method where taxable income or loss is calculated as the sum of net income (being the difference between receipts and payments (excluding private flows) plus the change in the tax value of assets over the period less the change in the tax value of liabilities) and tax law adjustments (ie the exceptions to the rules where government policy requires a different treatment (eg capital gains discount, gifts, R & D etc)). Both proposals have subsequently been abandoned.

68 Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper* (2002) (the Consultation Paper). The Consultation paper arose from the Government’s 15 October 2001 election policy (John Howard, Commonwealth of Australia, *Securing Australia’s Prosperity - The Coalitions Economic Policy* (2001)) announcing a review of Australia’s international tax system and the 2 May 2002 statement by the Treasurer clarified the Review’s terms of reference (see Treasurer, ‘Review of International Tax Arrangements’ (Press Release No 21, 2 May 2002)). See generally Michael Dirkis, ‘Reviewing an International Tax Review’ (2002) 6 *Tax Specialist* 68.

69 The Consultation Paper (Ibid) after examining the incorporation test, proposed consideration of options to clarify the test of company residency so that exercising central management and control alone does not constitute the carrying on of a business (Option 3.12).

70 Board of Taxation, Commonwealth, *International Taxation: A Report to the Treasurer* (2003) 109 (Recommendation 3.12).

deferred consideration of changes pending the release of a draft ruling by the Australian Taxation Office (ATO) to clarify the operation of those tests.⁷¹

Finally, the law of residency and, to a lesser extent, source, is confined by geographic jurisdictional boundaries (it is based upon physical (geographic) or territorial (domain of nations over land and sea) nexus with Australia).⁷² When these physical limitations are combined with the subjective nature of the source and residency concepts, scope exists for manipulation of a person's residency status, a business's residency status, or the geographic source of income, in order to reduce the incidence of Australian income tax.

Concerns about this manipulation have been heightened by the developments in mass communications technology and the spread of the Internet. As the Internet has no jurisdictional boundaries⁷³ it is argued that it is possible for some taxpayers to operate via the Internet in a particular country without actually being physically present in the country.⁷⁴ The ATO in its 1997 report on taxation and the Internet found that the application of the existing jurisdictional rules would be eroded in the Internet environment.⁷⁵ In particular, the Report found that a reason why the application of the residency rules was in serious doubt was that the rules were designed for an era in which electronic commerce did not exist.⁷⁶

Other jurisdictions, faced with similar challenges, have subjected their sufficient connection rules to review. Although the laws governing sufficient connection in those jurisdictions vary from those operating in Australia, many of the problems faced are similar. As a result of the reviews in the United States (1984), New Zealand (1988), the United Kingdom (1993) and Ireland (1994) changes were made to the fundamental rules

71 Treasurer, 'Review of International Tax Arrangements' (Press Release No 32, 13 May 2003).

72 Although Australian Taxation Office, Commonwealth, *Tax and the Internet: Discussion Report* (1997) (ATO's first Internet Report), 100 claims that both residency and source are tied by geographic jurisdictional boundaries, source is not purely a matter of geography as the source of income depends upon how it is produced, where it is produced and who pays it - see Robert Couzin in *Corporate Residence and International Taxation* (2002), 6.

73 Ibid 46.

74 Alan Tyree *et al*, *Computer Money Consulting Pty Ltd 's INNET 97/2 Report on Electronic Commerce Banking and Finance Issues* (1997) at URL: <http://www.ato.gov.au/content/Businesses/Downloads/cmc.rft>, Part 2 as at 31 December 2002. The report has subsequently been removed from ATO site. Other examples have been cited of the telecommuting knowledge workers (lawyers and consultants) and physicians remotely diagnosing patients on the Internet - see Dale Pinto, 'The Nation State: Will it survive globalisation?' (2000) 3 *Journal of Australian Taxation* 136, 140 and 147.

75 Finding 18, ATO's first Internet Report, above n 72, 100 and Pinto, above n 74, 148.

76 ATO's first Internet Report, above n 72, 35.

governing residency and source.⁷⁷ Given the recognition internationally for change and on going reviews in other jurisdictions (eg the United Kingdom⁷⁸) the lack of formal review in Australia is more difficult to justify.

In conclusion, given the fundamental importance of residency and source, it is surprising that except for the scant review given by the 1999 Review of Business Taxation and a narrow review of the corporate residency in the 2003 *Review of International Taxation Arrangements*, little attention has been given to their broad operation into the 21st century where globalisation of world trade and commerce and emergence of electronic commerce seem to undermine their physical jurisdictional basis.

B. A gap in the government and academic literature

The second reason for undertaking this study is that there is a gap in the literature. As mentioned above although there was governmental debate from the late 1880's until the 1930s on whether Australia should be taxed on a residency basis,⁷⁹ this analysis did not involve a systematic analysis of what particular transactions should be in Australia's tax net, except to generally exclude foreign source dividends and other income taxed in other jurisdictions. Thus, except for the Asprey committee and the 1999 Review of Business Taxation none of the other tax reform committees and inquiries⁸⁰ have considered the adequacy of the law governing residency and source. Inquiries conducted in other jurisdictions have also reviewed aspects of the law relating to residency and source. However, in the main, they too have limited their studies to analysing the particular methods for jurisdictional claim adopted in their jurisdiction or avenues for reform.⁸¹

77 The scope of these Reviews is discussed in Chapter 2, n 188. Although changes have occurred in a number of other countries, including South Africa, Israel, and Norway, it is not proposed to examine those processes in detail. For details of changes in South Africa, Israel, and Norway - see Ernest Mazansky, 'South Africa and its worldwide tax regime: Have we (almost) come full circle?' (2004) 58 *Bulletin for International Fiscal Documentation* 151,152-3, Michael Bricker and Dror Levy, 'Israel publishes tax reform proposal' (2000) 20 *Tax Notes International* 2695 and Sverre Hveding and Finn Backer-Grondahl, 'The concept of residence for tax purposes in Norway' (2002) 56 *Bulletin for International Fiscal Documentation* 427 respectively.

78 HM Treasury and Inland Revenue *Reviewing the Residence and Domicile Rules as they Affect the Taxation of Individuals: A Background Paper* (2003).

79 Harris, above n 42.

80 The Inquiries and Reviews are listed in Chapter 2, n 1, 3-12, 14.

81 See, eg, Denzil Davies, *Booth: Residence, Domicile and UK Taxation* (1995), A Farnsworth, *The Residence and Domicil of Corporations* (1939), Garth A Harris, *New Zealand's International Taxation* (1990) and Paul R Mc Daniel, 'The Steven L Cantor International Tax Symposium: Article: The US tax treatment of foreign source income earned in developing countries: A policy analysis' (2003) 35 *George Washington International Law Review* 265. More expansive studies

Various authors have examined the aspects of the residency and source law. The work undertaken by legal writers varies from the description of the law⁸² to legal analysis of select aspects of the law (ranging from reviewing the problems for expatriates and DTAs to specific case law and legislative analysis).⁸³ Both economists and lawyers have also focused upon the broader structural approaches to taxing international transactions.⁸⁴ This includes:

- commonality in approaches;⁸⁵
- the sustainability of either residency or source as basis of taxation;⁸⁶
- dual residency and double taxation;⁸⁷ and
- the impact of specific developments such as global trading,⁸⁸ electronic commerce⁸⁹ and tax induced migration of high wealth individuals.⁹⁰

include: Jinyan Li, 'E-commerce policy in Australia, Canada and the United States' (2000) 6 *University of New South Wales Law Journal* 40, and Couzin, above n 72.

82 See, eg, Geoffrey Lehmann and Cynthia Coleman, *Taxation in Australia* (5th ed, 1998), Mills, above n 42, Woellner above n 15 and Jeffrey Waincymer, *Australian Income Tax: Principles and Policy* (2nd ed, 1993).

83 See, eg, expatriates (Alice Abreu, 'The difference between expatriates and Mrs Gregory - citizenship can matter' [1995] *Tax Notes International* 1613)), DTAs (Tom W Magney, *Australia's Double Tax Agreements: A Critical Appraisal of Key Issues* (1994)), case law analysis (Alan Gotterson, 'The limit to Applegate' (1983) Nov *The Chartered Accountant in Australia* 17), and legislative analysis (Company residency tests (Peter J Gillies, 'Understanding company residence: Central management and control' (1989) 1(4) *CCH Journal of Australian Taxation* 52).

84 See, eg, Brian J Arnold and Michael J McIntyre, *International Tax Primer* (1995), and Hugh Ault, *Comparative Income Taxation: A Structural Analysis* (1997).

85 See, eg, Arnold, *Ibid*.

86 See, eg, Vogel I, above n 9, Klaus Vogel, 'Worldwide vs source of income - A review and revaluation of arguments (Part II)' (1988) 10 *Intertax* 310, Klaus Vogel, 'Worldwide vs source of income - A review and revaluation of arguments (Part III)' (1988) 11 *Intertax* 393, Jinyan Li, 'Rethinking Canada's source rules in the age of electronic commerce: Part 1' (1999) 47 *Canadian Tax Journal* 1077, Dale Pinto, *E-Commerce and Source-Based Income Taxation* (2003) and Kerrie Sadiq, 'Jurisdiction to tax and the case for threshold reform' (Paper presented at the 16th Australasian Tax Teachers Association Conference, Adelaide, 30 January 2004), Kerrie Sadiq, *Interjurisdictional Allocation of Multinational Banking Income: Aligning Taxation Principles with Economic Activity* (Phd Thesis, Deakin University School of Law, 2003) and supremacy of residence – John K Sweet, 'Formulating international tax laws in the age of electronic commerce: The possible ascendancy of residence-based taxation in an era of eroding traditional income tax principles' (1998) 146 *University of Pennsylvania Law Review* 1949 and United States, Staff of the Joint Committee on Taxation, *Background Materials on Business Tax Issues* (2002) at www.haise.gov/jct/x-23-02.pdf accessed on 30 January 2004.

87 See, eg, League of Nations (Bruins et al), *Report on Double Taxation* (1923) Doc EFS 73 F 19 cited in Seligman (1928), above n 55, 115, Kees van Raad, 'International: Dual residence' (1988) 28 *European Taxation* 241, Sir Josiah Stamp *The Fundamental Principles of Taxation* (1936), 130-42, Seligman (1928), above n 55, 114-142, and Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed, 1997).

88 See, eg, Robert A Green, 'The future of source-based taxation of the Income of multinational enterprise' (1993) 79 *Cornell Law Review* 18, Charles E McLure, 'Globalization, tax rules and national sovereignty' (2001) 55 *Bulletin for International Fiscal Documentation* 328, Charles Plambeck, 'The taxation Implications of global trading' (1990) 48 *Tax Notes* 1143 and Sadiq, above n 86, and Vito Tanzi, 'Globalization, technological development, and the work of fiscal termites' (2001) 26 *Brooklyn Journal of International Law* 1261.

89 See, eg, Bjorn Westberg, *Cross Border Taxation of E-commerce* (2002), Paul McNab,

In summary, despite several Australian governmental reports, commissioned studies and academic writing there has been no detailed, holistic, legal critical review addressing the practical adequacy of the current Australian law of residency and source against the generally accepted objectives of a “good” tax system (ie equity, efficiency and simplicity).⁹¹ This thesis seeks to fill that gap in the literature.

III. Thesis

The main thesis of this work is:

The law of residency and determination of source, as applying in the Income Tax Assessment Act 1997 (Cth) (the 1997 Act), is inadequate as the law fails in its practical application to satisfy the “essential objectives” of equity, efficiency, simplicity and the prevention of tax avoidance.

The sub-thesis of this work is:

The domestic law of residency and source can be modified within the jurisdictional framework to more closely meet these “essential objectives”.

‘International reaction to electronic commerce developments’ (1998) 27 *Australian Tax Review* 219, Pinto, above n 74, Dale Pinto, *E-Commerce and Source-Based Income Taxation* (2003), Nilesch Shah, et al ‘Taxing the internet gold rush’ (2000) 11 (3) *International Tax Review* 13, Tadmore, above n 3, and Melissa De Zwart, ‘Electronic commerce: Promises, problems and proposals’ (2000) 6 *University of New South Wales Law Journal* 305. For a summary of the OECD consideration of electronic commerce see OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001).

90 See, eg, Jagdish N Bhagwati and John Douglas Wilson (eds), *Income Taxation and International Mobility* (1989), Charles Bruce, ‘Permanent Tax Exile - The plight of former US citizens?’ (1996) 50 *Bulletin for International Fiscal Documentation* 205, Sanford Goldberg et al, ‘Taxation caused by or after a change in residence (Part 1)’ (2000) 21 *Tax Notes International* 643, Juhani Kesti, ‘Sweden: Tax treatment of cross-border employment income’ (1995) 35 *European Taxation* 409, OECD, *International Tax Avoidance and Evasion: Four Related Studies* (1987), L Pan (ed), *Chinese Overseas* (1999) cited in Nolan Sharkey, ‘An examination of the individual residency rules: Policy, practical operation and foreign comparisons’ (1999) unpublished, ATAX research paper, 3, and Martin Sullivan, ‘Democrats revisit expatriate tax: With neutrality and justice for all?’ (1999) 19 *Tax Notes International* 1705.

91 However, Michael J Graetz in *Foundations of International Income Taxation* (2003) has sought to explore the theoretical principles as they underpin international income tax (principally from a United States view).

IV. Approach adopted

The approach adopted in respect of the main thesis is to evaluate the law of residency and source against the objectives of equity, efficiency, simplicity and the prevention of tax avoidance. This process includes an examination of the current scope of residency and source rules, the tax policy underlying the rules (or the lack thereof) and the practical problems with their implementation and the legal limitations on the scope of the rules agreed through international agreements (eg double tax agreements). This involves looking at the practical adequacy of the law from the perspective of all users of the tax system,⁹² but in particular tax administrators, tax advisors and taxpayers.

The approach adopted in respect of the sub-thesis will involve comparison of the approaches adopted domestically in other jurisdictions, including the United States, Canada, United Kingdom, New Zealand, and Germany and evaluating any reform models developed against the objectives of equity, efficiency, simplicity and the prevention of tax avoidance.

V. The structure

The structure to be adopted in the thesis is as follows:

Chapter 2 defines the scope of the objectives of equity, efficiency, simplicity and the prevention of tax avoidance and justifies why these are the most appropriate measurement criteria for this legal review of residency and source.

Chapter 3 deals with the residency tests for individuals, and Chapter 4 with the residency tests for companies and trusts. Despite the existence of residency definitions related to superannuation funds in the tax laws these residency tests will not be evaluated as they

92 At a broad level the tax system has of a number of key stakeholders being:

- law makers (the parliament), Treasury, Office of Parliamentary Council (OPC), and Office of Legislative Drafting (OLD);
- the tax administrator (ATO) and tax system monitoring bodies (Board of Taxation, Inspector General of Taxation and the Australian National Audit Office (ANOA));
- judiciary;
- tax professionals (ranging from compliance focused return preparers (bookkeepers and tax agents) to tax advisors (tax agents, tax accountants and tax specialist lawyers (solicitors and barristers)); and
- users (academics, students and taxpayers (ranging from tax professions (such as corporate tax managers) to individuals who self prepare)).

fall outside the scope of the thesis.⁹³ Similarly, although the residency rules relating to “limited corporate partnerships” will be discussed in Chapter 4 (as these partnerships are treated as companies),⁹⁴ again partnerships⁹⁵ are also not generally reviewed as they fall outside the scope of the thesis.⁹⁶

Finally, chapter 5 deals with the three broad categories of territorial source law (personal, property and business income).

93 A “resident superannuation fund” is defined in the 1936 Act s 6E. The related definitions of a “resident approved deposit fund” and a “resident regulated superannuation fund” are defined in *Superannuation Industry (Supervision) Act 1993*, (Cth) (SISA) ss 20A and 10, respectively. The reasons for not reviewing superannuation funds are twofold. First, these definitions rely on the “central management and control” concept, which will be extensively evaluated in the context of company and trust residency rules. Secondly, as retirement policies are country specific, they drive the unique residency definitions used. For example, in Australia the definition of “resident superannuation fund” in the 1936 Act s 6E, seeks to ensure that the taxation concessions applying to Australian superannuation funds were only available to Australian resident funds whose membership were also mainly Australian residents (a complying superannuation fund). However, in the United States the “qualified retirement plan” concession is focused upon there being an American employer not on the residency status of the employee except where an amount paid by a foreign affiliate of an American employer (*Internal Revenue Code of 1986* (US) IRC § 401(a)). Therefore, jurisdiction comparisons offer no assistance in evaluating reform options for the purpose of the sub-thesis.

94 1936 Act ss 94K and 94J.

95 As a partnership is not a taxable entity under s 9-1 of the 1997 Act there is no specific definition of partnership residency. A partnership is defined in 1997 Act s 995-1 as “an association of persons carrying on business as partners or in receipt of ordinary income or statutory income jointly, but does not include a company”.

The tax liability is determined at the partner level. To calculate the partners share, however, the 1936 Act treats the partnership as a resident entity. Section 90 defines “net income”, “exempt income” and “partnership loss” in terms of a resident taxpayer (eg the income or loss of a partnership is determined as if the partnership is a resident taxpayer). Then, ss 92(1), (2) and (3) in determining the assessable income, loss and exempt income of a partner use the partner’s residency status. Given that the tax liability is determined at the partner level, any issues of residency of partners will be covered in the analysis of the law relating to the residency of individuals, companies and trusts in Chapters 3 and 4.

Similarly, the specific definitions of “Australian partnership” in ss 337 and 472 of the 1936 Act (which were inserted to ensure foreign income was taxable on an accrual basis where it arose from a partnership, which contained at least one Australian resident corporate partner) rely on specific company residency rules. An “Australian partnership” is defined for the purposes of Part X of 1936 Act by s 337 (as being an Australian partnership at a particular time if at least one of the partners is an Australian entity at that time) and for the purposes of Part XI of the 1936 Act under s 472 (as an Australian Partnership if at least one of the partners is an Australian entity (defined in s 471 as an “Australian partnership”, “Australian trust” or “Part XI Australian resident”) at that time). In terms of the sub-thesis, as partnerships are treated as either transparent or as taxable entities, jurisdictional comparisons offer no assistance in evaluating reform options for the purpose of the sub-thesis.

96 For discussion of partnerships see generally Kees van Raad and Rijkele Betten (eds), *The International Guide to Partnerships* (7 November 2003). However, there are double tax issues that arise from the taxation of transparent entities resident in one state as a taxable entity in another (see *Cahiers de Droit Fiscal International: International Tax Problems of Partnerships*, Vol LXXXa (1995)). The OECD commentary has been updated to deal with these problems in light of recommendations in the OECD report, *The Application of the OECD Model Convention to Partnerships* (20 January 1999). Also see John Avery Jones et al, ‘Characterization of other states’ partnerships for income tax’ (2002) 56 *Bulletin for International Fiscal Documentation* 288.

The structure adopted in Chapters 3 to 5 for evaluating each area of law is broadly similar. Each Chapter starts by defining the scope of the test in Australia's income tax law, before evaluating the practical application of each category of law against the objectives of equity, efficiency, simplicity and the prevention of tax avoidance. This examination includes consideration of problems arising from the developments in electronic commerce and, through comparative studies of the approaches adopted in other jurisdictions, explores alternatives for reform in light of the problems discovered.

In Chapter 6, the thesis and sub-thesis are evaluated in light of the evidence gathered and a summary of the findings made. Future areas of development will also be explored.

Finally, as tax law and policy are changing constantly it is important to state that the thesis has been written against the laws and policy announcements in existence as at 30 April 2004. However, in order to ensure currency, key selected developments in the law and policy that have occurred up to 31 October 2004 have been incorporated into the thesis.

Chapter 2

Methodology

I. Purpose of this Chapter

As stated in Chapter 1, the main thesis of this work is that the law of residency and source, as applying in the 1997 Act, is inadequate as the law fails in its practical application to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance. This leads on to consider the sub-thesis that the domestic law of residency and source can be modified within the jurisdictional framework to more closely meet these "essential objectives". The thesis is concerned with evaluation of the operation of the law, that is, it is a legal analysis of the main thesis and the sub-thesis. In order to be consistent with that approach it is important that the objectives used to test the effectiveness of the law will result in illustrative examples that demonstrate the success or failure of the current law and to judge any reform proposals.

The purpose of this Chapter is to justify why, in the context of this thesis, the four objectives identified from the myriad of possible tax policy objectives are the most appropriate tests for evaluating the thesis. This involves first setting out a range of possible tax policy objectives, drawing from major and minor Australian inquiries and reviews, major tax reform reviews conducted in other jurisdictions, independently commissioned studies and academic writing, which could be used to evaluate the adequacy of the law of residency and source.

A series of common tax policy objectives emerges from that analysis. First, there is wide spread use in evaluating the effectiveness of existing laws and the proposed tax reforms of the three tax policy objectives of equity, simplicity and efficiency. Second, underlying a number of most recent reform reviews, the policy objective of reducing tax avoidance is also commonly used. The scope of these four tax policy objectives is examined in detail in order to define each term and set out the process for measuring the extent to which the law of residency and source complies with the objectives. Given the legal focus of this study the evaluative process is qualitative in nature rather than quantitative or empirical.

In order to reinforce the appropriateness in the context of this thesis of the four selected objectives, other key tax policy objectives will be reviewed in order to illustrate why they were less appropriate in the context of this thesis than those selected.

Finally, a discussion of the weighting to be given to each tax policy objective is undertaken. This is necessary as a number of the objectives, if pursued in isolation can counter the pursuit of other objectives.

II. Background

As mentioned above, the first step is to explore a range of possible tax policy objectives, which could be used to evaluate the adequacy of the law of residency and source. In Australia, during the first sixty years of the Commonwealth's income tax regime, official independent tax reform inquiries were launched every decade or so (with the exception of the 1940's due to World War II and its aftermath). From the 1980's the tax reform process shifted to the bureaucracy (the Treasury, ATO and Board of Taxation), with independent inquiries used, if at all, to review bureaucratic generated tax reform proposals rather than proposals generated through receipt of evidence from the community. Political influences have in many cases been instrumental in the creation of these reviews.¹ The major reform events² over the last 80 years have been:

- First Royal Commission³ on Taxation (24 September 1920 to 15 December 1924);⁴
- Second Royal Commission on Taxation (6 October 1932 to 28 November 1934);⁵
- Commonwealth Parliamentary Committee on Taxation (February 1950 to March 1954);⁶

1 For example the Howard Governments' election proposals for a revamp of the Australian tax system (Peter Costello, Commonwealth of Australia, *Tax Reform, Not a New Tax, A New Tax System* (13 August 1998) (ANTS)), although conceived in Treasury, led to the creation of the Review of Business Taxation.

2 For an overview of these reform events see Michael Dirkis, 'Observations on the Development of Australia's Income Tax Policy and Income Tax Law' (2002) 56 *Bulletin for International Fiscal Documentation* 522.

3 A Royal Commission is an independent inquiry mechanism (usually with evidentiary compulsive powers) used for a wide variety of purposes in Australia.

4 Commonwealth, Royal Commission on Taxation, *Reports* (1920-24) (the 1920 Royal Commission). There were four reports.

- Commonwealth Committee on Taxation (3 December 1959 to June 1961);⁷
- Taxation Review Committee (14 August 1972 to 31 January 1975);⁸
- *Reform of the Australian Tax System*, Draft White Paper (1985);⁹
- Review of Business Taxation (14 August 1998 to 30 July 1999);¹⁰ and
- Review of International Taxation Arrangements (22 August 2002 to 28 February 2003).¹¹

These major Australian inquiries and other more limited Australian reviews,¹² major tax reform reviews conducted in other jurisdictions,¹³ independently commissioned studies¹⁴ and academic writing¹⁵ have used various tax policy objectives as a basis for evaluating

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- 5 Commonwealth, Royal Commission on Taxation, *Reports* (1933-34) (the 1932 Royal Commission). There were four reports.
 - 6 Commonwealth Committee on Taxation, *Reports* (1951-53) (Spooner Committee).
 - 7 Commonwealth Committee on Taxation *Report* (1961) (Ligertwood Committee).
 - 8 Taxation Review Committee, Commonwealth, *Full Report* (1975) (Asprey Report).
 - 9 Commonwealth, *Reform of the Australia Tax System: Draft White Paper* (1985).
 - 10 Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999).
 - 11 The Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper* (2002); Commonwealth, The Board of Taxation, Commonwealth, *International Taxation: A Report to the Treasurer* (2003) and Treasurer, 'Review of International Taxation Arrangements' (Press Release 13 May 2003).
 - 12 See, eg, reports released by the Treasurer (John Dawkins, Commonwealth, *Taxation of Financial Arrangements: A Consultative Document* (1993) and Peter Costello, Commonwealth, *Proposed Changes to the Taxation of Foreign Source Income: An Information Paper* (1996) (1996 FSI Paper) and those released by the Australian Taxation Office (Australian Taxation Office, Commonwealth, *Tax and the Internet: Discussion Report* (1997) (ATO's first Internet Report) and Australian Taxation Office, Commonwealth, *Taxation and the Internet: Second Report* (1999) (ATO's second Internet Report)).
 - 13 See, eg, Canada, *Report of the Royal Commission on Taxation* (1966) (the Carter Commission); Ireland, Commission on Taxation, *First Report* (1982), *Second Report* (1983), *Third Report* (1984) (O'Brien Commission) and New Zealand, Taxation Review Committee *Taxation in New Zealand, Report* (1967) (Ross Report). Examples from the United Kingdom includes United Kingdom, *Report of the Royal Commission on the Income Tax* Cmd 615 (1920) – in particular Report of the Sub-Committee on Double Taxation, Evidence Appendix 1, 168; United Kingdom, *Report of the Income Tax Codification Committee* Cmd 5131 (1936); United Kingdom, *First Report of the Royal Commission on the Taxation of Profits and Income* Cmd 8761 (1953); United Kingdom, *Final Report of the Royal Commission on the Taxation of Profits and Income* Cmd 9474 (1955) and United Kingdom, HM Treasury and Inland Revenue *Reviewing the Residence and Domicile Rules as they Affect the Taxation of Individuals: A Background Paper* (2003). Also see League of Nations (Bruins et al), *Report on Double Taxation* (1923) Doc EFS 73 F 19 cited in Edwin Seligman *Double Taxation and International Fiscal Cooperation* (1928), 122.
 - 14 See, eg, RI Downing, et al, *Taxation in Australia — An Agenda for Reform* (1964) (Researchers were appointed by the Social Science Research Council of Australia to develop proposals to improve equity of the Australian tax system); John Hewson and Tim Fisher, *Fightback! Taxation and Expenditure Reforms for Jobs and Growth* (1992) (Liberal and National Parties); and Paul Drum (ed), CPA Australia's, *Tax Reform: The Road Ahead* (2002).
 - 15 Graeme S Cooper, 'Income Tax Law and Contributive Justice: Some thoughts on defining and expressing a consistent theory of tax justice and its limitations' (1986) 3 *Australian Tax Forum* 297; David Goldberg, 'Acceptability, morality and balance in taxation' [2000] *British Tax Review* 106; Ann Harding, 'Tax reform, equity and social security' (1985) 2 *Australian Tax Forum* 223; Howard Pender *The Joy of Tax* (1997), 10 and 22-27 and Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) - version used Edwin Cannan (ed) (1904), reprinted (1961).

the effectiveness of existing tax laws and of potential reforms.¹⁶ Despite the myriad of tax policy objectives used in these reports and studies, a number of key common tax policy objectives can be identified. These key objectives of tax policy include questions such as:

- is the tax law consistent with Adam Smith's four principles of taxation:¹⁷ equality, certainty (extended to cover concepts such as clarity, consistency and stability¹⁸), convenience and economy;
- is it consistent with the policy reasons for its introduction;
- is it consistent with the Government's fiscal strategy;
- does it maximise economic efficiency;
- does it maximise the opportunities for broader microeconomic reform to contribute to an internationally competitive economy;¹⁹
- does it recognize the challenges of (international) tax competition;
- does it conform with neutrality benchmarks of capital export neutrality, capital import neutrality, and national neutrality;
- does it provide a secure source of revenue;
- does it improve simplicity and transparency;
- is it administratively efficient;
- does it reduce compliance and administrative costs;
- is it feasible (ie can be legislated and implemented); and
- does it prevent tax avoidance (ie create integrity in the system²⁰)?

A common thread in the reviews and studies conducted from Adam Smith in 1776²¹ to the Board of Taxation's 2003 report on the Review of International Taxation Arrangements²² is the use of the three traditional "good tax policy objectives" of equity,

16 See, eg, the Carter Commission n 13, Volume 1, 3, in discussing the relative importance of equity in its consideration of the objectives of a tax system noted that "[a] tax system can be judged from different points of view. Is the system fair? Does it contribute as much as possible to the growth and stability of the economy? Are the rights and liberties of the individual protected? Does it help to strengthen the federation?"

17 Smith, above n 15, 350-2.

18 1996 FSI Paper, above n 12, 19.

19 Ibid.

20 As a result of the 1999 Review of Business Taxation the use of the term "anti-avoidance" has been replaced by the word "integrity" (eg *New Business Tax System (Integrity Measures) Act 2000* (Cth)).

21 Smith, above n 15.

22 Board of Taxation, above n 11.

simplicity and efficiency in evaluating the effectiveness of existing laws and the proposed tax reforms. Academic commentators broadly accept these three tax policy objectives as the traditionally accepted criteria for evaluating tax systems.²³ Also underlying a number of most recent reform reviews has been concerns about the impact of tax avoidance and designing solutions to counter avoidance opportunities.

III. Reviewing the appropriateness of equity, simplicity, efficiency and the prevention of tax avoidance

Given the widespread use of equity, simplicity, efficiency and the prevention of tax avoidance in the various reviews, these four tax policy objectives are the logical choice to use in evaluating the two hypotheses. However, as wide spread use does not of itself necessarily mean that the objectives are appropriate in this context, it is important to review the scope of the equity, simplicity, efficiency and the prevention of tax avoidance objectives to ascertain the appropriateness of each.

A. Equity

The first policy objective is equity. The term in the tax law context has been used interchangeably in various reports with the terms fairness²⁴ and equality.²⁵ Equity is

23 See, eg, Geoffrey Lehmann and Cynthia Coleman, *Taxation in Australia* (5th ed, 1998), 65, Robin H Woellner et al *Australian Taxation Law* (13th ed, 2003), 26-37, Jeffrey Waincymer *Australian Income Tax: Principles and Policy* (2nd ed, 1993), 24-39, and Rodney Fisher 'Ralph Review: reform by name but not nature?' (2003) 7 *Tax Specialist* 61, 62. However, not all commentators agree that the objectives of simplicity, efficiency and equity are good predictors of the tax system. For example, Michael J Graetz, *Foundations of International Income Taxation* (2003), 5, in agreeing they are appropriate in domestic taxation, notes that in the international context there is "a remarkable lack of consensus", while others, such as Simon Blount 'The Art of Taxation' (2001) 16 *Australian Tax Forum* 345, 355, goes further arguing that the better predictors are the objectives of elasticity, complexity and invisibility. Further, Graeme Cooper, Richard Krever and Richard Vann, *Income Taxation: Commentary and Materials* (4th ed, 2002), 3, note that although the three tax policy objectives have dominated bureaucratic thinking since the 1970s, tax policy analysis in public finance literature has been based upon the use of welfare economics (ie optimal taxation).

24 The OECD uses fairness as one of its broad principles of taxation rather than equity, which is included under the neutrality principle. Fairness is defined as "taxation should produce the right amount of tax at the right time, and the potential for evasion and avoidance should be minimised. OECD *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001), 10.

25 However, New Zealand's Ross Report, above n 13, 15 warns that equity is not the same as equality. "While . . . the tax system should operate to reduce inequalities in distribution and wealth, this desire for equality should not be pressed to the point where it could have serious repercussions on personal savings and such incentives to economic activity, as effort, investment, enterprise, and the willingness to take risks." Also see Klaus Vogel, 'Worldwide vs Source of Income - A Review and Revaluation of Arguments (Part III)' (1988) 11 *Intertax* 393, 395-6. Also, "equity" in this context

generally accepted as an essential quality of any tax or tax system.²⁶ The Canadian Carter Commission best expressed the importance of equity in the tax system as follows:

[t]he first and most essential purpose of taxation is to share the burden of the state fairly among all individuals and families. Unless the allocation of the burden is generally accepted as fair, the social and political fabric of a country is weakened and can be destroyed. History has many examples of the severe consequences of unfair taxation. Should the burden be thought to be shared inequitably, taxpayers will seek means to evade their taxes. When honesty is dismissed as stupidity, self-assessment by taxpayers would be impossible and the cost of enforcement high. We are convinced that scrupulous fairness in taxation must override all other objectives²⁷

Despite the importance of the concept, the word “equity” can have many meanings in the taxation context.²⁸ Therefore, it is important to define what equity is for the purpose of the thesis. Implicit in defining equity is the need to specify the process for identifying the level of equity/inequity contained within the rules relating to residency and source.

1 *Defining equity*

The definition of equity adopted in a number of Australian inquiries is the two dimensional definition of horizontal and vertical equity.²⁹ Horizontal equity requires that “[i]ndividuals in similar circumstances should be taxed similarly”,³⁰ while vertical

is not equity in the sense of legal equitable principles – see Robert Couzin, *Corporate Residence and International Taxation* (2002), 27.

26 See, eg, 1985 Draft White paper, above n 9, 14, stated that “An equitable tax system is critical, not only to the attainment of economic and social objectives, but also to the maintenance of a basic respect for the tax system from which a high degree of voluntary compliance derives.” Similarly the New Zealand *Report of the Task Force on Tax Reform* (1982) (the Mc Caw Report), 68 notes that “[i]f a paramount consideration has been adopted, it is for fairness, or equity – on the ground that no system which is unfair and is perceived to be unfair will have the acceptability and relative permanence which are required of a good tax system”. Also see 1920 Royal Commission on Taxation, above n 4, 3 and the Asprey Report, above n 8, 12. Equity is also seen as a crucial objective of good tax administration - Inspector-General of Taxation, Commonwealth, *Issues paper Number 2: Policy Framework for Review Selection* (2003), 1 and 3 at URL: <http://www.igt.gov.au> as at 31 December 2003.

27 Carter Commission, above n 13, 4 and Review of Business Taxation, Commonwealth, *A Strong Foundation* (1999), 63.

28 Asprey Report, above n 8, 12 noted that “. . . in tax matters as in law and ethics, it is an ideal exceedingly difficult to define and still harder to measure”. Also see Vogel III, above n 25, 393 who views equity (which embodies the concepts of equality and integrity) as a moral and legal concept which cannot be defined, only explained or paraphrased.

29 A Strong Foundation, above n 27, 63 described two other forms of equity - administrative equity (administrative procedures that do not inappropriately advantage some and disadvantage others) and transitional equity (the fairness of transitional arrangements associated with changes to tax legislation).

30 This definition has wide spread acceptance eg Board of Taxation, above n 11, 32; the 1985 Draft White Paper, above n 9, 14; and the McCaw Report, above n 26, 68. In A Strong Foundation,

equity requires that the “. . . tax burdens should depend upon ability to pay . . . , the greater burden falling on those more able to pay”.³¹

As these definitions focus upon equity as it relates to taxpayers they have often been classified as “individual” or “inter-individual” equity as opposed to “inter-nation equity”, which focuses on ensuring that each country linked in a cross border transaction receives an equitable share of tax revenue arising from that transaction (ie an equitable distribution of the competence to tax).³² Equity in the context of inter-nation equity depends upon tax rates in the source country and the allocation of the tax base between the source and residency country.³³ Thus “individual” equity is primarily a domestic tax policy objective, while “inter-nation” equity is an international tax policy issue.

Thus, both “individual” equity and “inter-nation” equity would be potential tools for evaluating the effectiveness of the rules relating to residency and source. However, as the focus of the thesis is on the effectiveness of Australia’s domestic rules as they operate within Australia’s jurisdictional claim, the focus of the following discussion will be on “individual” equity, rather than “inter-nation” equity.³⁴

above n 27, 63 and 75 it is suggested that horizontal equity can be achieved through ensuring all forms of income (wages, rent, capital gains, etc) are taxed equally

31 This definition has wide spread acceptance eg Board of Taxation, above n 11, 32; the 1985 Draft White Paper, above n 9, 14, and the McCaw Report, above n 26, 68. This latter concept has its origins in Adam Smith original maxim that “[t]he subjects of every state ought to contribute towards the support of the Government, as nearly as possible, is, in proportion to the revenue which they respectively enjoy under the protection of the state (Smith, above n 15, 350). The Asprey Report, above n 8, 12 notes that the concept is consistent with the taxation of non-residents on the derivation of Australia source income. In A Strong Foundation, above n 27, 63 it is suggested that vertical equity can be achieved through personal taxes and welfare systems and ensuring that business income is ultimately taxed in the hands of individuals through the personal tax system.

32 Nancy H Kaufman, ‘Fairness and the taxation of international income’ (1998) 29 *Law and Policy in International Business* 145, 153-4 and Vogel III, above n 25, 394-5. The concept was first identified by Peggy B Musgrave (Peggy Brewyer Richman (now Musgrave), *Taxation of Foreign Investment Income - An Economic Analysis* (1963)).

33 For further discussion see Kaufman, *ibid*, Peggy B Musgrave, ‘The treatment of international capital income’ in Head, John G (ed) *Taxation Issues of the 1980s* Conference Series No 1, Australian Tax Research Foundation (1983), 279, Peggy B Musgrave, ‘Sovereignty, entitlement, and cooperation in international taxation’ (2001) 26 *Brooklyn Journal of International Law* 1335, and Dale Pinto, *E-Commerce and Source-Based Income Taxation* (2003), 35.

34 Michael J Graetz ‘Taxing international income: Inadequate principles, outdated concepts, and unsatisfactory policies’ (2001) 26 *Brooklyn Journal of International Law* 1357, 1399 argues that with equity “[a]s with efficiency, a national rather than world-wide perspectives seem appropriate.”

2 Identifying equity

Despite general acceptance of the two part definition of “individual equity”, and a view that equity can be measured in isolation in the context of the income tax,³⁵ there are a number of difficulties in identifying the level of equity/inequity.

A problem in measuring horizontal equity is that it is very difficult to identify when people are in similar economic circumstances.³⁶ It gives rise to questions of whether the inquiry should be based upon taxpayers' incomes and/or their wealth, their level of commitments (ie the assessable amount)³⁷ or whether the economic circumstances of associates (eg their family and associated entities) should be considered or just the individual's income (ie the taxing unit).³⁸ Other problems include determining when ability to pay should be taken into account (ie the timing of the assessment)³⁹ and determining the appropriate rate at which taxes should increase with ability to pay.⁴⁰ Even the question of capacity to pay is difficult as the horizontal equity concept assumes that people with the same capacity to pay tax are located at the same point on the scale, where as this may not be the case.⁴¹

The measurement of vertical equity has similar problems. The problem with the ability to pay concept is, while a higher ability-to-pay should imply a higher tax liability, the relationship may in fact:

... be proportional, progressive or regressive, or some mixture of these and objective considerations have to be blended with important value judgements about the redistributive goals of the community before a conclusion on the shape of this relationship can be reached.⁴²

35 Asprey Report, above n 8, 258.

36 See, eg, Asprey Report, above n 8, 13, Woellner, above n 23, 28.

37 Waincymer, above n 23, 32.

38 The 1985 Draft White Paper, above n 9, 14. The Asprey Report, above n 8, 13 notes that personal factors such as health and size of family are felt to be relevant differentials between taxpayers, while personal factors such as sex, race and religion are irrelevant. Also see the Cater Commission, above n 13.

39 Waincymer, above n 23, 32-33 argues that it is difficult to determine ability to pay at any point as income is rarely earned evenly over a lifetime.

40 1985 Draft White paper, above n 9, 14.

41 McCaw Report, above n 26, 68.

42 Ibid.

Thus, the determination of vertical equity and the resultant distributional issues is based upon value judgments (often founded on ethics or aesthetics)⁴³ and therefore, has been difficult to pursue.⁴⁴

It is also clear that measuring vertical equity can only be assessed in relation to the tax system as a whole⁴⁵ as deviations from a comprehensive tax base generally accrue to the benefit of high income individuals.⁴⁶ This explains the focus of recent reform processes on changes to the comprehensive tax base.⁴⁷ It is argued that “[i]f certain types of income are omitted from the tax base, or if particular expenditures are treated preferentially, then taxpayers with similar taxpaying capacities will not be taxed equally.”⁴⁸ Thus, as the focus of the thesis is on specific aspects of the income tax system within Australia’s jurisdictional claim, then global measurement has little relevance to that process.

The challenges in measuring the level of equity/inequity may make it difficult to use the two part definition in its pure form. These difficulties are reinforced by concerns that pursuit of theoretical equity is an unattainable goal that can only lead to a tax Act that is too scientific and that the attempt will involve a sacrifice of simplicity and convenience out of all proportion to the value of the results achieved.⁴⁹ There is also a clash between economic efficiency and vertical redistribution.⁵⁰

43 Henry C Simons, *Personal Income Tax* (1938) cited in John G Head ‘Tax Reform: A quasi-constitutional perspective’ in Graeme Cooper (ed) *Tax Avoidance and the Rule of Law* (1997), 155, 157.

44 Ibid Head citing WJ Blum and H Kalvern Jr, *The Uneasy Case for Progressive Taxation* (1953). Also Downing, above n 14, 47 warns that rapid and substantial movements to income equality through steeply progressive income tax rates would have serious effects.

45 McCaw Report, above n 26, 68. This is a different focus to Adam Smith, above n 15, 350, who in acknowledging that the various heads of revenue (taxes on rent, profit and wages) will fall unequally upon different taxpayers, focused on “. . . inequity which is occasioned by a particular tax falling unequally even upon that particular private revenue which is affected by it.”

46 1985 Draft White Paper, above n 9, 14.

47 See, eg, ANTS, above n 1, which included recommendations to alter indirect tax base, including included recommendations to introduce a goods and services tax (GST) and A Tax System Redesigned, above n 10, recommendations 4.1 to 4.24 proposing the Tax Value Method (TVM), which was intended to replace Australia’s current traditional measurement of income.

48 Ibid.

49 1932 Royal Commission, above n 5, 6. Evidence was presented before the Commission that “[e]ven if theoretical equity were possible, it would be dearly bought if it could not be obtained without the complexities of the present system, which create great difficulty in administration and irate taxpayers, with the result the whole Act comes to be condemned as unintelligible and oppressive.”

50 See generally JE Meade et al, *The Structure and Reform of Direct Taxation* (1978), 7-23 and AM Okun *Efficiency and Equity: The Big Tradeoff* (1975) cited in Yuri Grbich, Adrian Bradbrook and Kevin Pose, *Revenue Law: Cases and Materials* (1990), 40-42.

Further, it is generally recognized that necessity causes many arbitrary elements in the taxation system, such as the scale of progression, exemptions and deductions. It is also accepted that taxes are usually a “poor instrument for achieving social (equity) objectives.”⁵¹ Thus, although it may be an idle “. . . hope that a system based upon such a foundation can be theoretically equitable in all its parts”,⁵² a good tax system is one that minimizes the various clashes between equity and other policy objectives.

In summary, what is clear from the literature is that the appropriate measurement of equity depends upon social, political and economic judgments of the persons seeking to measure it. Thus, from the above it is clear there are a number of fundamental difficulties in qualitatively measuring equity. However, it is possible to identify where there is a failure to achieve equity or where the system in operation results in inequitable outcomes.

3 The use of equity within the thesis

Despite these problems, all the reports and authors see equity as a crucial tax policy objective of a good tax system.⁵³ It is also clear that taxation based upon world wide income (residency) of individuals is important in achieving the individual equity policy objective⁵⁴ and that a comprehensive income tax is also a important for achieving horizontal equity.⁵⁵ Therefore, the question is not should equity be used, rather how it can be used within the thesis to evaluate the effectiveness of the law relating to residency and source.

Given the lack of an accepted measurement process, the equity of the legal rules relating to residency and source will be evaluated in the thesis qualitatively by identifying when the law does not, in certain circumstances, give rise to either horizontal or vertical equity. Thus, the thesis will highlight where individuals in similar circumstances are not

51 1996 FSI Paper, above n 12, 19.

52 1932 Royal Commission, above n 5, 6.

53 However, some authors are starting to question, whether vertical equity, if still a legitimate economic policy aim, remains an existing policy objective of taxation in the US in light of the anti-taxation political trend over the last 10 years – see, eg, Thomas F Field, ‘A report from Rip Van Winkle’ in Ranjana Madhusudhan (ed), *National Tax Association: Proceedings of 95th Annual Conference* (2002), 85.

54 2002 Consultation Paper n 11, 84.

55 Simons, above n 43, 158.

being taxed similarly or where the tax burdens do not fall upon those with the greatest ability to pay.

Similarly when focusing on reform of the legal rules relating to residency and source, reform recommendations will also be measured qualitatively by illustrating where the proposed reforms result in changes that ensure that individuals in similar circumstances will be taxed similarly or where the tax burdens fall upon those with the greatest ability to pay.

B. Efficiency

The second policy objective is efficiency. The efficient use of the nation's resources is a long standing policy objective of public policy, including tax policy,⁵⁶ as:

[w]ith a more efficient tax system, resources will be more likely to move into activities where they will generate the largest economic gains to the nation, rather than activities where they will simply yield the largest tax gain to investors.⁵⁷

As efficiency is aimed at ensuring the optimum allocation and use of resources, it is inevitably linked to other tax policy objectives such as ensuring consistency with national or governmental economic objectives (fiscal strategies), ensuring economic growth and providing for an international competitive economy.⁵⁸ It is based upon the presumption that, except for certain public goods and services, the private market will ensure reasonable, efficient allocation of resources.⁵⁹

1 Defining efficiency

Efficiency, in the tax context, has been historically defined in terms of economic efficiency (ie minimising the distortion of economic activity such as patterns of investment or saving) and in terms of administrative efficiency (ie minimising the compliance and administrative costs arising from the structural design or the costs of

56 Asprey Report, above n 8, 16.

57 1985 Draft White Paper, above n 9, 14.

58 As with other policy objectives, many reports merge the various tax policy objectives – eg Ross Report, above n 13, 15.

59 John G Head, 'Capital gains taxation - An economist's perspective' (1984) 1 *Australian Tax Forum* 148, 150 and Klaus Vogel, 'Worldwide vs Source of Income - A Review and Revaluation of Arguments (Part II)' (1988) 10 *Intertax* 310.

collection).⁶⁰ This dual aspect has meant that the term has been traditionally used interchangeably in various reports with the terms “convenience” and “economy”.⁶¹

The Board of Taxation has defined economic efficiency as:

. . . in raising revenue, the business tax system should interfere as little as possible with the best use of existing national resources, with the efficient allocation of risk, and with long term economic growth.⁶²

Thus, an efficient tax is one that does not unduly distort the market.

As efficiency involves the reduction of distortions to a minimum,⁶³ the concept of tax neutrality is now commonly used interchangeably with efficiency in various reports⁶⁴ and by many commentators.⁶⁵ The use of the term “neutrality” rather than “efficiency” is to ensure that the focus of the review is on improving the economic efficiency of the national or global economy and to ensure the international competitiveness of locally based businesses by minimising the tax distortions that affect individuals’ and business’ choices. Thus, as economic neutrality benchmarks are used in analysing the optimal taxation treatment domestically and internationally,⁶⁶ it is necessary to define efficiency and neutrality within those contexts for the purpose of this thesis.

Before looking at the subset of efficiency/neutrality tax policy objectives (benchmarks), it is important to distinguish the concept of “revenue” neutrality, which has been used as a tax policy objective in some reform reviews.⁶⁷ However, the focus of “revenue”

60 See, eg, 1996 FSI Paper, above n 12, 19, which focused only on administrative efficiency.

61 1920 Royal Commission, above n 4, 125F and 131. The “convenience” concept has its origins in Smith’s third maxim, which requires that “[e]very tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it (Smith, above n 15, 351). Flexibility is also seen as an attribute of efficiency – Ross Report, above n 13, 15

62 Board of Taxation, above n 11, 31.

63 Head, above n 59, 150.

64 Asprey Report, above n 8, 16, ATO’s second Internet Report, above n 12, 10, Board of Taxation, above n 11, 31; 2002 Consultation Paper n 11, 31, and Inspector-General, above n 26, 1. In fact the OECD includes equity under the neutrality principle, rather than treating it as a separate principle of taxation - OECD, above n 24, 10.

65 See, eg, John Azzi ‘Policy considerations in the taxation of foreign source income’ (1993) 47 *Bulletin for International Fiscal Documentation* 547, 548, Waincymer, above n 23, 27 and Drum, above n 14, 11. However, Klaus Vogel, ‘Worldwide vs Source of Income - A Review and Revaluation of Arguments (Part I)’ (1988) 8-9 *Intertax* 216 suggests the reverse stating that efficiency of capital allocation is the underlying basic criterion of neutrality.

66 2002 Consultation Paper n 11, 91 notes its use in analysing the optimal taxation treatment of inbound, outbound and conduit income.

67 A Tax System Redesigned, above n 10, v, vii and 18. The revenue neutrality policy objective had been earlier stated in A Strong Foundation, above n 27, 6, and Review of Business Taxation,

neutrality is not on removing distortions, rather, it is on ensuring that the reform proposals do not increase or decrease the current levels of tax revenues (ie are revenue neutral).⁶⁸

(a) Domestic efficiency/neutrality

The Review of Business Taxation noted that there were two neutrality principles that bore centrally upon efficiency in the domestic context: investment neutrality and risk neutrality.⁶⁹ Investment neutrality requires no taxing differentials in respect of the type of investment, the type of entity, entity financing alternatives, the type of income distribution, and distributions relative to retention. Implicit in investment neutrality is that business engaged in electronic commerce should be subject to equivalent arrangements as businesses engaged in physical commerce.⁷⁰ Risk neutrality means that the tax system should ensure that it minimises distortions to the pattern of undiversifiable risk bearing by investors.⁷¹

Historically, a further subset was administrative efficiency, which is focused upon removal or reduction in the transaction costs associated with compliance and revenue costs.⁷² However, minimisation of transaction and compliance costs is also a function of

Commonwealth, *A Platform for Consultation: Discussion Paper 2 Building on a Strong Foundation* (1999), 6.

68 A Platform for Consultation, *ibid*.

69 A Strong Foundation, above n 27, 69. These elements have been further categorised as investment neutrality (if investment incentives are required for social or economic measures, they should be explicit, efficiently targeted, transparent and costed), entity neutrality (choice of business entity should be neutral), financing neutrality (neutrality in choice of transaction funding), payout neutrality (neutrality between dividends, retained profits and share buy-backs), income source neutrality (neutral in its treatment of different income, expenditure sources and asset and liability types), and neutral in its impact in financial innovation – Drum, above n 14, 12

70 United States, Department of the Treasury, Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (1996), 19, para 6.2 at URL: <http://www.fedworld.gov/tel/internet.txt> located on 31 December 2003, OECD, above n 24, 10, ATO's first Internet Report, above n 12, 96 and ATO's second Internet Report, above n 12, 8. Also see Bjorn Westberg *Cross-border Taxation of E-commerce* (2002), 57-65.

71 A Strong Foundation, above n 27, 75.

72 Waincymer, above n 23, 27 and 1985 Draft White paper, above n 9, 15. This collection aspect has its origins in Adam Smith's final maxim that "[e]very tax ought to be so contrived as both to takeout and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. A tax may either takeout or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the following four ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax . . . Secondly, it may obstruct the industry of the people . . . Thirdly, by the forfeitures and other penalties which those unfortunate individual individuals incur who attempt unsuccessfully to evade the tax, it may frequently ruin them, and thereby put an end to the benefit which the community might have received from the employment of their capital . . . Fourthly, by subjecting the people to frequent visits and the odious examination of the taxgatherers, it may expose them to much unnecessary trouble, vexation, and oppression" (Smith, above n 15, 350-52).

the simplicity tax policy objective and often, as is in this thesis, simplicity is seen as a separate and primary objective rather than as “a facet of economic efficiency”.⁷³ Similarly, although the prevention of tax avoidance and evasion can give rise to a lack of neutrality, it has been decided to deal with the prevention of tax avoidance as a separate evaluative criterion in the thesis (see the discussion in Part III D).

(b) International efficiency/neutrality

In the international context, the neutrality objectives commonly used are capital export neutrality, capital import neutrality and national neutrality.⁷⁴ All three neutrality objectives exist in the international tax rules of most jurisdictions.⁷⁵

(i) Capital export neutrality

The term capital export neutrality (CEN) aims for neutrality in international investment decisions by ensuring that regardless where income is earned (domestically or overseas), residents are taxed on that income at the same effective tax rate⁷⁶ ensuring equal pre-tax rates of return on investments between countries.⁷⁷ It is argued that CEN is achieved solely by taxation based upon country of residence.⁷⁸ Therefore, tax measures aimed at achieving CEN seek to offset the effects of source country taxation through tax credits for foreign tax paid by residents through domestic foreign tax credit regimes and/or under tax treaty obligations to provide credits for foreign tax.⁷⁹

(ii) Capital import neutrality

The term capital import neutrality (CIN) aims for neutrality in international savings decisions by ensuring that regardless of where capital is invested (domestically or overseas) the income derived, is taxed at the same rate,⁸⁰ so that the effective after-tax

73 Graetz (2001), above n 34, 1410.

74 2002 Consultation Paper n 11, 8. Richard L Doernberg, *International Taxation in a Nutshell* (5th ed, 2001).

75 See, eg, Australia (2002 Consultation Paper n 11, 93) and the United State (Doernberg, *ibid*, 6).

76 Board of Taxation, above n 11, 31 and 2002 Consultation Paper n 11, 92.

77 2002 Consultation Paper n 11, 92.

78 Graetz (2001), above n 34, 1364-5.

79 2002 Consultation Paper, above n 11, 93. The broad focus of the CFC and FIF measures is aimed at ensuring CEN – see Paul J Keating, Commonwealth, *Taxation of Foreign Source Income: A Consultative Document* (1988), 5.

80 Board of Taxation, above n 11, 32.

rate of return on an investment in any particular country is the same for all investors regardless of investors' place of residence.⁸¹ It is argued that CIN is achieved by giving primacy to tax to the source country.⁸² Therefore, tax measures aimed at achieving CIN include "the income tax exemption for non-portfolio dividends (or branch income) an Australian company receives from a listed country, the non-taxation of active business income retained offshore"⁸³ and recommendations in the Consultation paper for a reduction in the level of company tax on direct investment offshore.⁸⁴

(iii) National neutrality

The term national neutrality⁸⁵ aims for neutrality in investment decisions of residents by ensuring equality between the pre-tax (gross) return on domestic investments and the post-foreign tax return on foreign investments.⁸⁶ This occurs where foreign investment income of a resident investor is taxed (without deferral) at the same domestic tax rate as domestic income and with foreign tax treated as a deductible expense.⁸⁷ An Australian tax measure consistent with national neutrality is the denial of franking credits for foreign tax paid by Australian companies and their offshore subsidiaries.⁸⁸

2 Identifying efficiency/neutrality

The efficiency of the tax system can be measured from both domestic and international views, focusing upon neutrality objectives.

81 2002 Consultation Paper n 11, 92.

82 Graetz (2001), above n 34, 1365.

83 2002 Consultation Paper n 11, 93. Other measures aimed at ensuring CIN include the exemption for foreign active income under the CFC and FIF measures.

84 Ibid, 8. The Consultation Paper claims that the reduction in the company tax rate will improve the competitiveness of Australian companies operating overseas and raising capital internationally. Further, for individual investors and funds, the options are based on balancing capital export and national neutrality benchmarks.

85 Graetz (2001), above n 34, 1380 notes that this concept was also developed by Peggy Musgrave.

86 2002 Consultation Paper, above n 11, 92.

87 Ibid.

88 Ibid, 93.

(a) Measuring domestic neutrality

The efficiency of the tax system domestically can be determined by a number of aspects, being the level of taxation,⁸⁹ the method of collection⁹⁰ or the form that the system takes.⁹¹ Crucial in any evaluation is the degree to which the income tax base is comprehensive,⁹² as substantial domestic neutrality in relation to business financial and investment decisions can only be achieved through a comprehensive income tax.⁹³ However, given the focus of the thesis on the effectiveness of particular tax provisions, many of these measurement approaches are not relevant because they relate to overall tax system performance at the macro level.

(b) Measuring international neutrality

Although domestic neutrality is a vital tax policy objective, problems arise due to:

... interactions between the tax systems of the domestic country, the country of the source of the income or residence of the investor, and third countries (in relation to conduit cases).⁹⁴

Efficiency will also be compromised even where the same level of income tax is imposed in Australia and in another jurisdiction, if profitability differential arises from an international tax difference, such as an excise. Thus, in order to evaluate the efficiency of the system, it must be measured as a whole, including the impact of foreign taxes on the system.⁹⁵

89 The 1985 Draft White paper, above n 9, 15 notes that the "... deleterious effects on efficiency are more difficult to avoid as the total level of taxation increases. This is one reason why the Government is committed to pursuing tax reform without increasing the overall tax burden."

90 As mentioned above, in this thesis administrative efficiency will be dealt with under simplicity. However, for completeness, administrative efficiency is measured by the size of the excess burden, which is the cost imposed by the system over and above the revenue actually collected (Waincymer, above n 23, 27).

91 Board of Taxation, above n 11, 31. The 1985 Draft White paper, above n 9, 15 notes that "... [a]ny tax will tend to discourage the activity on which it is imposed."

92 The 1985 Draft White paper, above n 9, 15 notes that "... that the more comprehensive the tax system is the less distortion there will be of the relative rewards of different types of work, of the relative attractions of work and leisure, of the relative returns from different types of investment, and of the relative prices of goods and services. That is to say, efficiency, like equity, is generally enhanced by the adoption of a comprehensive tax base."

93 Simons, above n 43, 158 and A Strong Foundation, above n 27, 75.

94 2002 Consultative Paper n 11, 92.

95 Asprey Report, above n 8, 258 and Meade, above n 49.

The three international neutrality objectives (CEN, CIN and National neutrality) provide a useful conceptual framework for measuring efficiency/neutrality. However, as the three objectives do adopt conflicting policy directions,⁹⁶ it is important in discussing measurement to briefly summarise the strengths and weaknesses of the three objectives. The purpose of this examination is not to ultimately determine which of the three objectives has primacy on their merits, rather it is to illustrate the difficulties involved in using these three international tax policy objectives in a thesis focused on qualitative analysis within the context of Australia's jurisdictional claim.

CEN is often proposed as the dominant theory as it maximises global welfare and is consistent with the "horizontal and vertical equity benchmarks for individual taxpayers under a progressive tax system."⁹⁷ However, CEN is not universally supported, nor perfect, as the economic modeling underlying the adoption of CEN is based upon unrealistic assumptions associated with perfect competition such as the residence of taxpayers is fixed, demand for capital is also fixed and the company tax payable in a country is independent of the economic infrastructure provided by that country.⁹⁸ The models also ignore the dynamic benefits exposure to overseas markets may bring to domestic business.⁹⁹

The other two international tax policy objectives have similar strengths and weaknesses. CIN is seen as more practical being based upon considerations of international competitiveness rather than economic theory.¹⁰⁰ Further, it has been argued that deviation from CIN may in fact favour high marginal cost producers ahead of low cost producers.¹⁰¹ However, CIN is seen as an impossible goal in light of the differences in national tax structures, rates and benefits.¹⁰²

In light of the above, the choice between CEN and CIN can be determined empirically.¹⁰³ CEN is favoured as:

96 Ibid, 91-2 and Graetz (2001), above n 34, 1365.

97 2002 Consultation Paper, *ibid*, 92 and Vogel II, above n 59, 311.

98 Graetz (2001), above n 34, 1366, Philip Anderson, 'Economic policy considerations in the taxation of foreign source income' (1988) 5 *Australian Tax Forum* 395, 408, and 2002 Consultation Paper n 11, 92.

99 2002 Consultation Paper n 11, 92.

100 Pinto, above n 33, 26.

101 Graetz (2001), above n 34, 1366-7.

102 Pinto, above n 33, 24 (relying on Peggy Musgrave) and Vogel II, above n 59, 311.

- the cost of distortions associated with the location of investment (CEN) exceeds those associated with the allocation of savings (CIN); and,
- savings (based upon the relative elasticity between saving and investment) are less responsive to changes in taxation than investment.¹⁰⁴

National neutrality also has weaknesses. It is argued that national neutrality can discourage foreign investment as deductions can offer far less relief from double tax than foreign tax credits. The other concern is if it is adopted by all nations, it would result in a reduction in worldwide economic output.¹⁰⁵

In summary, the measurement of international neutrality is clouded by the fact that there is little consensus in favour of the primacy of any one of the international neutrality policy objectives,¹⁰⁶ and compounded by the fact that it is impossible to achieve all three international neutrality policy objectives simultaneously.¹⁰⁷ Even if it is possible to adopt a particular policy objective, solutions may be difficult to secure, as it is not within Australia's jurisdiction to control efficiency at a global level.¹⁰⁸ As a result the question about what is the theoretical optimal international tax arrangement is left open and remains the subject of much debate.¹⁰⁹

(c) Summary

From the above discussion it is clear that evaluation of efficiency/neutrality is usually undertaken at the macro level based on economic models.¹¹⁰ As the focus of the thesis is on specific aspects of the income tax system within the context of Australia's jurisdictional claim, then global measurement using economic modeling has little relevance to that process.

103 Graetz (2001), above n 34, 1366.

104 Ibid.

105 Graetz (2003), above n 23, 29.

106 This lack of consensus is due in part to compliance and administrative considerations, but is mainly due to all nations, including Australia, having a national interest in protecting their share of taxing rights - see 2002 Consultation Paper n 11, 91-2 and Graetz (2001), above n 34, 1371.

107 Ibid.

108 Asprey Report, *ibid.* Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed, 1997), 14 notes that the best possible efficiency in the international context in allocation is obtained through the state of residency taxing on a world wide basis and granting a credit for the tax levied in the state of source (capital export neutrality). If taxation is restricted to state of source on the territorial principle, capital import neutrality is achieved by economic inefficiency.

109 2002 Consultation Paper n 11, 91-2 and Graetz (2001), above n 34, 1365.

110 Vogel I, above n 65.

3 *The use of efficiency (neutrality) within the thesis*

Despite the difficulty in getting a clear consensus on the preferred neutrality objective, the difficulties in quantitative measurement of efficiency/neutrality, and the fact that complete neutrality is unattainable,¹¹¹ what is clear is that efficiency/neutrality is a crucial tax policy objective. In fact the Asprey Committee argued that neutrality should be the general aim when considering efficiency, and that departures should be made only where other measures will not give rise to an efficient result.¹¹²

Therefore, as the thesis is focused on the legal rules relating to residency and source as opposed to the operation of the system as a whole, any lack of efficiency (neutrality) identified in the legal rules will be evaluated qualitatively. This will be done by identifying when the law in certain circumstances gives rise to distortions such as a taxpayer being taxed differently due to the market in which the taxpayer operates (eg physical or electronic). A lack of neutrality may also be demonstrated where income is taxed differently depending upon its characterisation or its source. This evaluation will not consider distortions due to the nature of business structure adopted. However, although the impact of tax avoidance and evasion will be evaluated under the prevention of tax avoidance evaluative criterion, in respect of neutrality, distortions caused by tax avoidance will be briefly noted.

C. Simplicity

The third objective criterion is simplicity.¹¹³ The test, in the tax law context,¹¹⁴ has been used widely in various reports¹¹⁵ and in some circumstances, interchangeably with the

111 Ross Report, above n 13, 15 notes not only is complete neutrality unattainable it is also not justified where all other economic objectives are sought to be satisfied.

112 The Asprey Report, above n 8, 16 argues that some discriminatory taxes that discourage output to encourage societal good (eg health) are in fact an “efficiency tax”.

113 There are a myriad of papers on this topic which Cooper has classified into three themes: “. . . extolling the virtues of simplicity in taxation as self-evident, describing the cost of the scourge of complexity, and suggesting remedies to the problem of complexity of varying degrees of sophistication” – see Graeme S Cooper, ‘Themes and issues in tax simplification’ (1993) 10 *Australian Tax Forum* 417, 419.

114 There is also the concept of “economic simplicity”, which “emphasises the interaction between the tax law and the economy (as characterised by the population of taxpayer)” and is based upon the operating cost of the tax – see Binh Tran-Nam, ‘Tax Reform and Tax Simplicity: A New and ‘Simpler’ Tax System?’ (2000) 6 *University of New South Wales Law Journal Forum* 6, 7.

115 Examples of reports focused principally on simplicity include New South Wales, Taxation Investigation Committee *Report* (1937) and the 1936 UK Income Tax Codification Committee, above n 13 (which was charged with preparing a draft Income Tax Bill which aimed at making the law more “intelligible to the taxpayer . . . promote uniformity and simplicity”).

term certainty,¹¹⁶ which in turn embodies concepts such as clarity, consistency¹¹⁷ and stability.¹¹⁸ The importance of simplicity is that in its absence tax laws are complex (uncertain)¹¹⁹ and poorly designed which in turn:

- imposes high compliance costs on the community;¹²⁰
- imposes high administrative costs on the tax authorities;¹²¹
- results in socially unproductive and costly tax litigation;¹²²
- are counterproductive to the economic development of the country,¹²³ in particular by jeopardizing economic neutrality;¹²⁴

116 Certainty is Adam Smith's second maxim, ie that "[t]he tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person . . . The uncertainty of taxation only encourages the insolence and favours the corruption of an order of men who are naturally unpopular, even where they are neither insolent nor corrupt." - Smith above n 15, 350-1. Also see the 1920 Royal Commission, above n 4, 125F.

117 Tran-Nam above n 114, 6, sees clarity, consistency and certainty as some of the essential requirements for legal simplicity. Also see A Strong Foundation, above n 27, 64 and ANTS, above n 1, 105-27.

118 Although this is advocated by Lord Howe of Aberavon, 'Simplicity and stability: the politics of tax policy' [2001] *British Tax Review* 113, 123, Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (1992), 119 and Inspector-General, above n 26, 1, there is not universal acceptance of stability being an essential criteria for simplicity – see Cooper (1993), above n 113, 460.

119 A recent example of the expansive drafting style is the new debt equity rules - *New Business Tax System (Debt and Equity) Act 2001* (Cth). It is argued that in a self assessing environment such expansive drafting does not make sense as it produces "imprecise, fluid and elastic provisions" which lack clear policy direction and creates uncertainty for taxpayers - see Ian Stanley, 'The debt equity rules: Debt interests' (Paper presented at NSW Division of the Taxation Institute of Australia Seminar, Sydney, 16 August 2001), 1.

120 These costs take two forms. First, from September 1985, when it was first announced that traditional taxation administration arrangements were to be replaced with self assessment, a large compliance burden was shifted from the tax administrator to the taxpayer. For a history of its piecemeal introduction from 1 July 1986 onwards, a discussion of the failure of the system to fully address the power imbalance created through ensuring accessible and binding information and recommendations for reform see Michael Dirkis and Michael Payne-Mulcahy, 'Time for a change: Self assessment 14 years on' (2002) 36 *Taxation in Australia* 417.

Second, this community cost can be increased through incompetent advisers. Complex income tax laws, which make it impossible to form a defensible view in respect of the law, discourage thorough tax advisers, as they are unable to justify their fees for such uncertain outcomes. As a result, less thorough advisers can charge less for their equally uncertain advice (the so called Gresham's Law) – see and HH Monroe, 'Fiscal Statutes: A Drafting Disaster' [1979] *British Tax Review* 265, 268; Committee on Tax Policy of the New York State Bar Association's Tax Section, 'A Report on Complexity and the Income Tax' (1972) 27 *Tax Law Review* 325, 327; Mark Burton and Michael Dirkis, 'Defining Legislative Complexity: A case study - the Tax Law Improvement Project' (1995) 14 *University of Tasmania Law Review* 198, 205; and Margaret McKerchar, *The Impact of Complexity upon Tax Compliance: A Study of Australian Personal Taxpayers Research Study No 39*, Australian Tax Research Foundation (2003).

121 As complexities continue to rise, so do complex boundaries for the ATO to police and the total cost of the tax system (ie, the sum of compliance costs and administrative costs borne primarily by the ATO) – Chris Evans, et al, *A Report into Taxpayer Costs of Compliance* (1997), 86 and Cedric Sandford, 'International Comparisons of Administrative and Compliance Costs of Taxation' (1994) 11 *Australian Tax Forum* 291, 301.

122 1985 Draft White Paper, above n 9, 15.

- acts against public involvement in policy development;¹²⁵ and
- generates disrespect for the rule of law.¹²⁶

It is further claimed that a simpler tax system results in lower administrative costs (with fewer resources being devoted to socially unproductive activities such as tax planning and tax litigation)¹²⁷ and gives rise to many economic benefits.¹²⁸

1 *Defining simplicity*

The simplicity principle of tax policy design is that “tax rules should be clear and simple to understand, so that taxpayers know where they stand”¹²⁹ (ie a good tax system should be as simple as possible).¹³⁰ Thus, it is argued that where possible, tax reform measures capable of ready comprehension and application should be preferred over more complex alternatives in order to increase the certainty of what is or is not taxable, and to increase the clarity of the tax system.¹³¹ In other words, a reform should only be adopted if it can be legislated and can be implemented (ie the reform is feasible).¹³²

However, despite the self-evident nature of the concept, the myriad of writings on the topic present what appears to be an unending array of definitions of what constitutes

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- 123 See, eg, Law Reform Commission of Victoria, *Plain English and the Law* (1987), 59; Ed, ‘Counting the costs’ (1991) 26 *Taxation in Australia* 248; and Brian Nolan and Tom Reid, ‘Re-writing the Tax Act’ (1994) 22 *Federal Law Review* 448, 450
- 124 Complexity can create a lack of economic neutrality by favouring projects with more predictable tax outcomes - Burton, above n 120, 204.
- 125 Certainty about tax laws allows for a widespread, informed debate on taxation policy issues, which is essential to the functioning of democracy - see C Havighurst and R Hobbet, ‘Foreword’ (1969) 34 *Law and Contemporary Problems* 671 cited in Burton, above n 120, 206.
- 126 It is argued that if taxpayers lose faith with the tax law as a body of rules, voluntary compliance will suffer and the government in introducing measures, which protect the revenue, will incur greater cost - see Ross Parsons, ‘Income tax - An Institution in Decay?’ (1986) 3 *Australian Tax Forum* 233. Adam Broke, ‘Simplification of tax or I wouldn’t start from here’ [2000] *British Tax Review* 18 sees four causes of complexity: diversity, volume, drafting and language.
- 127 Law Reform Commission of Victoria, above n 123, 62 and 1985 Draft White Paper, above n 9, 14.
- 128 Cooper (1993) suggests “. . . there is little empirical work that can verify the grand, but largely unsupported claims for the benefits of simplification” (above n 113 at 420 and also at 426-432).
- 129 OECD, above n 24, 10. The definition adopted by the Board of Taxation (“. . . a tax system should be transparent, easily understood, and keep administrative and compliance costs to a minimum”) stretches the definition to include the administrative efficiency objective - Board of Taxation, above n 11, 32.
- 130 1985 Draft White Paper, above n 9, 15. It is argued that it is self-evident. Lord Howe, above n 117, 113 in citing Alice G Abreu, ‘Untangling tax reform’ (1996) 33 *San Diego Law Review* 1355, notes “‘If taxes had existed in the Garden of Eden, the serpent wouldn’t have needed an apple; the promise of a simpler tax system alone would have seduced Eve.’ She said it all, didn’t she? Tax simplification is a hugely seductive subject.”
- 131 1985 Draft White Paper, above n 9, 15 and ANTS, above n 1, 17-18 and 129-152.
- 132 1996 FSI Paper, above n 12, 19.

simplicity.¹³³ Cooper, having reviewed the literature, suggests that the many and varied concepts discussed by writers can be distilled down to seven concepts that are embodied in the notion of simplicity. These concepts are:

- predictability (ease of understanding) of a rule's intended (and actual) scope;
- proportionality (complexity proportional to the policy);
- consistency (avoids arbitrary distinctions);
- low compliance burdens;
- easy administration;
- co-ordination with other tax rules; or
- clear expression.¹³⁴

Although other writers have distilled what appear to be different concepts underlying simplicity, these differences are generally based upon subtle differences in classification and expression.¹³⁵

2 Identifying simplicity

When attempting to measure simplicity the focus of measurement has been on the level of complexity,¹³⁶ rather than attempting to measure simplicity.¹³⁷ It is generally accepted that income tax is in varying degrees intrinsically complex.¹³⁸ However, as there have

133 See, eg, Asprey, above n 8, 15 which defines a tax simple if the official cost of administration and taxpayer compliance costs are low (ie both are the ancient cannon of certainty).

134 Cooper (1993), above n 113, 424.

135 For example: predictability, enforceability, difficulty and manipulability – Joel Slemrod 'Complexity, compliance costs and tax evasion' in JA Roth and JT Scholtz, *Taxpayer Compliance: Social Science Perspectives* (1986) 156 cited in Tran-Nam, above n 114, 6. Similarly, Westberg (above n 70, 65-71 and 73-74) identifies predictability and proportionality as underlying certainty and administrative ease and ease of compliance costs as underlying simplicity.

136 Complexity, as with simplicity, has been defined in a number of ways including the cost of compliance arising from the lack of certainty eg New York State Bar Association, above n 120, 327.

137 Cooper (1993) above n 113, 425 argues that there is no measure of simplicity.

138 1936 UK Codification Committee, above n 13, 17 noted "[t]he impossibility of producing a simple code of income tax law must be obvious to anyone who reflects for a moment . . . The countless complications of modern life must inevitably reflect in the complexity of the code which has to cope with them". This was cited with approval by the Commissioner of Taxation - see the Commissioner of Taxation, Commonwealth, *Eighteenth Report* (1936), 14. Also see Stanley S Surrey, 'Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail' (1969) 34 *Law and Contemporary Problems* 673, 680; 1985 Draft White Paper, above n 9, 15, Michael Carmody, 'Issues Confronting Australia's tax system' (Paper presented in Financial Review Leaders Lunch, Sydney, 29 July 2002), 14 (copy located at: <http://www.ato.gov.au/content.asp?doc=/content/Corporate/sp200207.htm> accessed 31 December 2003) and Gary Banks (Chair, Productivity Commission), 'The good, the bad and the ugly:

been continual complaints in reports and in the literature about the complexity of the tax system since its inception,¹³⁹ it is difficult to gauge from that research what is a valid means of measuring complexity so an accepted level of complexity can be determined (ie, the ability to determine when is a measure is not too complex).¹⁴⁰

There are a number of methods adopted to measure complexity. One methodology is to measure the complexity of taxation law by the readability of the legislation¹⁴¹ with the solution seen in simplification by improving readability through “plain English” drafting.¹⁴² However, this solution has been substantially criticised as mere readability does not ensure understanding to such a level that enables the provision to be applied in all circumstances. Further, no matter how clearly expressed, a complex rule remains complex¹⁴³ and a simple provision, which contains an administrative discretion couched in general terms, may mask huge complexity.¹⁴⁴

economic perspectives on regulation in Australia’ (Paper presented at the Conference of Economists, Business Symposium, Canberra, 2 October 2003), 3.

139 1932 Royal Commission, above n 5, 6

140 GSR Wheatcroft, ‘The Present State of the Tax Statute Law’ [1968] *British Tax Review* 377; Robert Couzin, ‘The Process of Simplification’ (1984) 32 *Canadian Tax Journal* 487; John Clark, ‘Statutory Drafting’ [1980] *British Tax Review* 326; and Charles E McLure, ‘The Budget Process and Tax Simplification/ Complication’ (1989) 45 *Tax Law Review* 25.

In fact, whilst the objective of the now defunct Tax Law Improvement Project was to reduce the complexity of the Act, nowhere in the Commonwealth, Joint Committee of Public Accounts *An Assessment of Tax - A Report on an Inquiry into the Australian Taxation Office*, Report No 326 (1993), which was the genesis of the project, or the various publications associated with the project (in particular George Gear, Commonwealth, *Tax Law Improvement Project: The Broad Framework* (1994) Information paper No 1 and George Gear, Commonwealth, *Tax Law Improvement Project: Building the New Law* (1995) Information paper No 2) is there a definition of complexity.

141 Law Reform Commission of Victoria, above n 123, 60 and Simon James and Alan Lewis, ‘Fiscal Fog’ [1977] *British Tax Review* 371. The measurement methods include the Flesch score (measures readability by sentence length and the number of syllables) and Cloze procedure (measures readability by assessing a reader’s ability to correctly replace missing word in a passage of legislation).

142 The Law Reform Commission of Victoria rewrote Division 16E of Part III at the request of the Law Council of Australia and submitted a draft to the Australian Taxation Office for comment see Law Reform Commission of Victoria, *Annual Report* (1991), 7. It was touted as a great advance (see Ed, ‘Snappy language: The Dingo Division’ (1991) 26 *Taxation in Australia* 246), but met with criticism (see Ian Turnbull, ‘Simplification: Dingos Revisited’ (1992) 27 *Taxation in Australia* 79; and Anthony H Slater, ‘Principle or prescription? Simplified tax legislation involves much more than “plain English” redrafting’ (1993) 1 *Taxation in Australia Red* 119). Also see response David St L Kelly, ‘Simplification: Dingos Revitalised’ (1992) 27 *Taxation in Australia* 270.

143 John F Avery Jones ‘Tax laws: Rules or principles?’ [1996] *British Tax Review* 580, 582 and Lehmann and Coleman, above n 23, 65.

144 Ian G Wallschutzky, ‘TLIP: Stage 1 – Benchmarking’ (1995) 12 *Australian Tax Forum* 115; Richard J Vann, ‘Improving Tax Law Improvement: An international perspective’ (1995) 12 *Australian Tax Forum* 193; Ian Turnbull, ‘Drafting simple legislation’ (1995) 12 *Australian Tax Forum* 247; and Simon James, Adrian Sawyer and Ian G Wallschutzky, ‘The complexities of tax simplification: Progress in Australia, New Zealand and the United Kingdom’ (1998) 14 *Australian Tax Forum* 29.

This approach is also globally difficult to achieve as readability is dependant upon the target audience's reading ability, which will vary depending upon factors such as age, education level and occupation. A failure to clearly articulate the intended audience will undermine the value of any rewrite (eg the Taxation Laws Improvement Project (TLIP)).¹⁴⁵ Despite TLIP over a two year period altering the target of the tax law rewrite from the general community to tax agents, the language of the draft legislation released did not change over that time period, nor were any earlier drafts revamped to reflect the newly identified audience.¹⁴⁶

Suggestions that the length of the law gives rise to complexity¹⁴⁷ are subject to similar superficiality criticisms. In fact length may increase simplicity by providing a fuller explanation. In an electronic age, length is not as problematic.¹⁴⁸

The other key measurement approach is to focus on the cost of compliance.¹⁴⁹ Most academic research has focused on the compliance costs from the taxpayer's perspective¹⁵⁰ as the global costs of collection are easily obtained from the budgets of

145 Burton, above n 120. Subsequent studies indicate that although readability can be improved, this improvement does not necessarily translate into reduced compliance costs - see Adrian Sawyer, 'Rewriting tax legislation: Reflections on the New Zealand's experience' (2003) 57 *Bulletin for International Fiscal Documentation* 578, 587.

146 The Project's first information paper (above n 138, 3) identified taxpayers as the target of the rewrite. The second information paper stated the target was both the taxpayer and the tax adviser (above n 138, 5), while by late 1994 the Project Team determined that it was impractical to focus on the taxpayer audience. The law rewritten as a result of this focus would have been unsuitable for the reader group who could be expected to make the greatest use, the tax professional (Brian Nolan and Tom Reid, 'Re-writing the Tax Act' (1994) 22 *Federal Law Review* 448, 457). By June 1995 it was decided that the project should target "the suburban tax agent as a typical audience" (Brian Nolan, Robert Allerdice and Simon Gaylard, 'The Tax Pyramid' (Paper presented at Tax Law Improvement Project seminars, Perth, Sydney, Melbourne and Brisbane, in June/July 1995), 3).

147 See, eg, Trevor Boucher, 'Tax Simplification - Some Different Dimensions' (paper presented to the Monash University Law School Foundation, Melbourne, 3 September 1991), 2; edited version 'The simplification debate: Too simplistic' (1991) 26 *Taxation in Australia* 277.

148 Note the insight of H Stone, 'Some Aspects of the Problem of Law Simplification' (1923) 23 *Columbia Law Review* 320 that the ever increasing length of legislation would put pressure on some new technology to facilitate the expeditious location of relevant law.

149 Joel Slemrod, 'Did the Tax Reform Act of 1986 simplify tax matters?' (1992) 6 *Journal of Economic Perspective* 45 suggests that the total operating costs of the tax system is a measure of the complexity of the system - cited by Jeffrey Pope Policy Implications of research on compliance costs of taxation' in John G Head and Richard Krever (eds), *Taxation Towards 2000* Conference Series No 19, Australian Tax Research Foundation (2000), 617, 637.

150 Key academic studies on community compliance costs, which set out the trends in current Australian compliance cost research, include: Chris Evans, Jeff Pope and John Hasseldine (eds), *Tax Compliance Costs: A Festschrift for Cedric Sandford* (2001); Margaret McKerchar 'The effects of complexity on unintentional noncompliance for personal taxpayers in Australia' (2002) 17 *Australian Tax Forum* 3; and a series of studies by Jeff Pope et al starting with Jeffrey Pope, Richard Fayle and Mark Duncanson, *The Compliance Costs of Personal Income Taxation in Australia 1986/87* Research Study No 9, Australian Tax Research Foundation (1990) and more recently Jeff Pope and Prafula Fernandez, 'The Compliance costs of the superannuation surcharge tax' (2003) 18 *Australian Tax Forum* 537. Comparative compliance costs studies include: OECD,

the revenue authorities.¹⁵¹ Although there has been a lot of research, the accuracy of the results have been questioned due to sample size, response rates¹⁵² and the difficulties in measuring the impact upon compliance costs when changes are implemented.¹⁵³

Thus, a lack of an agreed measurement benchmark means that it is difficult to validate a claim that a particular tax reform measure will produce a simpler income tax.¹⁵⁴

3 *The use of simplicity within the thesis*

From the above discussion what is simplicity and how is it measured is the subject of much conjecture and debate. Again, what is not questioned by any of the reports or authors is that simplicity is a key tax policy objective of a good tax system.¹⁵⁵ Therefore the question is how it can be applied within the thesis.

Given the legal doctrinal focus of this thesis, many of the quantitative measurement benchmarks are not relevant. Therefore, for the purpose of the thesis, the simplicity of, or conversely, the complexity of, the legal rules relating to residency and source will be illustrated qualitatively through identifying when the law does not in certain circumstances give rise to simple clear outcomes, ie the circumstances illustrate that the law does not meet the seven concepts underlying the simplicity notion suggested by Cooper.¹⁵⁶ Thus, if the law in application is:

Businesses' Views on Red Tape: Administrative and Regulatory Burdens on Small and Medium-Sized Enterprises (2001), located at: <http://www1.oecd.org/publications/e-book/4201101E.PDF> on 31 December 2003, which analyses and compares the small and medium business tax compliance costs for the period April 1998 to May 1999 (pre GST for Australia) of 11 countries, including Australia; Sandford, above n 117 for a contra on the reliability of such studies; and Chris Evans, et al 'Taxation compliance costs: Some recent empirical work and international comparison' (1998) 14 *Australian Tax Forum* 93.

151 An example of a recent Government tax compliance cost study is: Australian Taxation Office, Commonwealth, *International Benchmarking of GST administration* (2004), obtained by *The Australian* under Freedom of Information Act 1982 (Cth) 19 January 2004, 24. More generic studies on "whole of Government" compliance costs on small business include: Commonwealth, House of Representatives Standing Committee on Industry, Science and Technology *Small Business in Australia – Challenges, Problems and Opportunities: Recommendations and Main Conclusions* (1996) and Small Business Deregulation Task Force, Commonwealth, *Time for Business: Report of the Small Business Deregulation Task Force* (1996).

152 Joel Slemrod 'Which is the simplest tax system of them all' in Henry J Aaron and William G Gale (eds), *Economic Effects of Fundamental Tax Reform* (1996) and Banks, above n 138, 5.

153 Cooper (1993), above n 113, 426.

154 Burton, above n 120, 203.

155 Despite this acceptance it has been difficult to achieve see, eg, Graetz, above n 34, 1410 notes "simplicity always seems to be the forgotten stepchild of income tax policy. Routinely lip service is offered to the idea that tax law ought to be as simple to comply with and administer as possible; then, after a nod and a wink, vaulting complexity overleaps itself."

156 Cooper (1993), above n 113, 424.

- not predictable – there is difficulty in understanding a rule’s intended (and actual) scope;
- not proportional – its complexity is disproportional to the complexity of the policy;
- not consistent – involves arbitrary distinctions;
- associated with the imposition of high compliance burdens;
- difficult to administer;
- not co-ordinated with other tax rules; and
- expressed unclearly,

then it will be considered to have failed the simplicity objective in that circumstance, for that stakeholder. When focusing on reform, recommendations will be similarly examined using the policy objective to illustrate where a recommendation does give rise to greater simplicity within the context of Australia’s jurisdictional claim.

D. Prevention of tax avoidance

A fourth and final policy objective is the prevention of tax avoidance and evasion. Avoidance and evasion creates inequity of the system,¹⁵⁷ reduces the productivity and efficiency of the economy,¹⁵⁸ impacts adversely on government revenues, distorts macroeconomic policy, threatens the legitimacy of the tax system, erodes moral standards¹⁵⁹ and results in a waste¹⁶⁰ or misallocation of economic resources.¹⁶¹ Although the prevention of tax avoidance and evasion appears to be more a strategy for achieving equity¹⁶² and efficiency or an outcome of the achievement of simplicity, it was expressed overtly as an objective in the 1985 White Paper¹⁶³ and has been used in other

157 Downing, above n 14, 128.

158 JA Kay, ‘The economics of tax avoidance’ [1979] *British Tax Review* 354, 356.

159 Neil Brooks, ‘The challenge of tax compliance’ in Chris Evans and Abe Greenbaum (eds), *Tax Administration: Facing the Challenges of the Future* (1998), 7 and 12-15.

160 Downing, above n 14, 128.

161 Tax avoidance impacts upon distribution of resources between individuals and between different activities and sectors of the economy - Kay, above n 158, 356. Also see Christopher Bajada, *The Cash Economy and Tax Reform* Research Study No 36, Australian Tax Research Foundation (2001), 31-33.

162 Above n 27 and quote in text from Carter Commission.

163 1985 Draft White Paper, above n 9, 15.

reports as a justification for recommending change.¹⁶⁴ Thus, prevention of tax avoidance and evasion is a relevant evaluative criterion in its own right.

The causes of avoidance and evasion include structural defects in tax legislation (such as difficulties in defining the tax base, multiple rates of tax on elements of the same tax base,¹⁶⁵ steep progressive income tax¹⁶⁶ and deficiencies in decision making and tax collection mechanisms¹⁶⁷), increased burden of taxes and government regulation,¹⁶⁸ increase in means-tested transfers, stagnating real incomes and increases in unemployment, increases in self-employment, shift to services, forces of globalisation and a decline in tax morality.¹⁶⁹

1 *Defining tax avoidance and evasion*

The terms “tax evasion”, “tax avoidance” and “tax planning” are often used interchangeably to describe the process by which taxpayers organise their affairs to reduce their overall tax liability. However, despite this common usage, each term has a specific legal meaning.¹⁷⁰

Tax evasion, which is criminal in nature,¹⁷¹ is the reduction of tax by failing to comply with the law by not disclosing all income or by over claiming deductions.¹⁷² Tax

164 See, eg, the 1920 Royal Commission recommendations on taxation at source for dividends (above n 4, 131) and the OECD uses the prevention of avoidance and evasion as part of its “effectiveness and fairness” taxation principle – OECD, above n 24, 10. Also see Inspector-General, above n 26, 1.

165 Kay, above n 158, 356.

166 Bajada, above n 161, 29

167 Yuri Grbich, *Institutional Renewal in the Australian Tax System* (1984), 1.

168 Smith, above n 15, 352, notes that “. . . an injudicious tax offers a great temptation to smuggling . . . The law, contrary to all the ordinary principles of justice, first creates the temptation, and then punishes those who yield to it”.

169 Neil Brooks, above n 159, 9-11. Neil Bookes at 19 –22 summaries the various research models used to explain the causes of avoidance and evasion, eg economic, psychological, sociological and pragmatic models. Also see Bajada, above n 161, 29-31. Attitudinal studies have been also undertaken to explore perceptions of fairness and tax avoidance, see, eg, Lin Mei Tan and Carol Chin Fatt, ‘The impact of tax knowledge on perception of fairness towards taxation: an exploratory study’ (Paper presented at the 11th Australasian Tax Teachers Conference, Canberra, 6 February 1999).

170 Michael Brooks and John Head, ‘Tax avoidance: In economics, law and public choice’ in Cooper (1997) above n 43, 53, 54 note that to an economist there would be no distinction between the different types of tax avoidance. Also see Frans Vanistendael, ‘Judicial interpretation and the role of anti-abuse provisions in tax law’ (1997), in Cooper (1997), *ibid*, 131 and Jeffrey Waincymmer, ‘The Australian tax avoidance experience and responses: A critical review’ (1997) in Cooper (1997) *ibid*, 247, 249.

171 Geoffrey Lehmann, ‘Judicial and statutory restrictions on tax avoidance’ in Richard Krever (ed) *Australian Taxation Principles and Practice* (1987), 295.

172 Asprey Report, above n 8, 143.

avoidance, which lies somewhere between tax evasion and tax-planning activities, is a process by which tax is reduced by entering into transactions which have perceived legal consequences, but have no practical effect other than creating a deduction or reducing income.¹⁷³ Tax planning is the minimisation of taxation to the extent it is legally possible and commercially practicable to do so.¹⁷⁴

However, there is a fine line between tax avoidance and tax planning.¹⁷⁵ What falls within each category depends upon perception and the legal context prevailing.¹⁷⁶ For example, where tax planning becomes commercialised (ie arrangements that are marketed, such as the equity linked bonds and controller superannuation arrangements, which were marketed in the late 1990s), the ATO takes the view that the line between legitimate tax planning and avoidance has been crossed. The ATO refers to this marketing process as “aggressive tax planning”.¹⁷⁷ When this line is crossed is often uncertain¹⁷⁸ and it has taken the ATO over four years to attempt a definition.¹⁷⁹ The ATO defines “aggressive tax planning” arrangements to be:

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- 173 Lehmann, above n 171, 295 and Asprey Report, above n 8, 143. Vanistendael, above n 170, 131 notes that “the distinction between legal tax avoidance and illegal tax evasion is crucial but non-lawyers tend to treat them as the same thing.”
- 174 Lehmann, above n 171, 295 and Vanistendael, above n 170, 132. The legality of tax planning is supported by the courts. In *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1, 19-20 Lord Atkin stated that “[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”
- 175 This is a result of the conflict between the doctrine of *Inland Revenue Commissioners v Duke of Westminster* (ibid), which is based on a literal approach to interpreting tax legislation (taxpayers are taxed on the form of a transaction and not its substance) and to a purposive approach (law interpreted in accordance with the purpose or policy underlying the legislation. The purposive approach is supported by a general anti-avoidance provision (Part IVA of the 1936 Act) and an express legislative direction to the courts that when interpreting a provision they should give it the construction which favours the purpose of the legislation (*Acts Interpretation Act* 1901 (Cth) ss 15AA and 15AB). Also see Asprey Report above n 8, 143 and Carter Commission, above n 13, Vol 3 Appendix A, 538.
- 176 Philip F Vineberg, ‘The Ethics of Tax Planning’ [1969] *British Tax Review* 31, 35 notes that he “. . . once suggested a rather subjective test of the difference between tax avoidance and tax evasion. If you have a bright plan on how to save taxes, that is tax avoidance. If somebody else has a scheme to save taxes that is tax evasion”. When this line is crossed is often uncertain - Stan Ross and Philip Burgess, *Income Tax: A Critical Analysis* (2nd ed, 1996), 293, 302.
- 177 Despite the Commissioner extolling the success in curbing aggressive tax planning, and reflecting that “[a]ggressive tax planning undermines the policy intent of the law and erodes community confidence in the fairness and equity of the tax system,” the Commissioner did not define the term from when first mentioned in 1999 (Commissioner of Taxation, ‘Stand on aggressive tax planning feature of Tax Office Annual Report,’ ATO Media Release Nat 99/74, 26 October 1999).
- 178 This was confirmed by Australian National Audit Office, Commonwealth, *The Australian Taxation Office's Management of Aggressive Tax Planning* (Audit Report No 23 2003-2004) release 29 January 2004, paras 9 and 1.6, which states that aggressive tax planning is a ‘grey’ concept, which changes overtime, and what transactions are caught may be viewed differently by the community and the ATO.

. . . those which, in the ATO's view, are designed to attempt to place a participant in a position of gaining tax benefits either not available under the law or contrary to the intended policy of the law. It would be expected that the arrangement would be generally of a kind that the anti-avoidance provisions apply, on the assumption that the claimed tax benefits would be otherwise available under the general provisions of the law.¹⁸⁰

As well as domestic tax avoidance, tax avoidance or evasion can occur across jurisdictions. The terms have the same meaning as they do in the domestic context, merely the mechanisms used are different.¹⁸¹

2 Measuring tax avoidance and evasion

Much research in terms of tax evasion has focused upon measuring the so-called "black economy".¹⁸² Techniques include voluntary survey and samples, non-voluntary tax auditing, labour market statistics, growth of large denominations of currency, monetary methods, and a range of economic modeling techniques.¹⁸³ In respect of tax avoidance, again the focus has been on the amount of revenue avoided by taxpayers engaging in the activity. Similarly, as both these behaviors result in falling revenue and create inequity in the system, the usual response to evasion and avoidance is through piece-meal

179 This lack of response occurred despite clarity being actively sought by the tax representative bodies over a two year period - eg Australian Taxation Office, Commonwealth, National Tax Liaison Group (NTLG) Minutes for 9 March 2001, item 5, at URL <http://www.ato.gov.au/large/content.asp?doc=/content/10503.htm&page=2#H8> as at 9 February 2004, and Australian Taxation Office, Commonwealth, National Tax Liaison Group (NTLG) Minutes for 2 September 2003, item 2, at URL <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/40916.htm&page=5#H7> as at 9 February 2004.

180 NTLG 2 September 2003, *ibid*, Action Item NTLG0309/2. Also see list of indicators ANOA, above n 177, Appendix 2.

181 International tax avoidance and tax evasion are facilitated through the use of tax havens, the use of head companies in low tax jurisdictions, conduits for channeling income via tax treaties and bank secrecy rules – OECD *International Tax Avoidance and Evasion: Four Related Studies* (1987). The off shore tax avoidance undertaken is not subtle or contrived and in most cases it is undertaken in complete disregard of the myriad of legislative controls. These controls include transfer pricing rules, revised debt/equity rules dealing with thin capitalisation, a foreign tax credit system, foreign source income measures relating to controlling interests in companies and trusts, and the so called FIF provisions relating to non-controlling interests greater than \$50,000 in trusts, companies and foreign life assurance policies.

182 Bajada above n 161, 20-28 and Chris Trengove, 'Measuring the hidden economy' (1985) 2 *Australian Tax Forum* 85.

183 See Cash Economy Task Force, Commonwealth, *The Cash Economy Under the New Tax System - Third Report* (2003) at URL: <http://www.ato.gov.au/content/downloads/N9544CEbookfinal.pdf> as at 31 December 2003. The Task Force concluded that while various studies estimate the cash economy to be between about 3% and 15% of GDP, the higher estimates are highly improbable given the small business sector's contribution to GDP. The Task Force also notes the modeling techniques which result in estimates at the high end of the range have been criticised by the OECD. For a contrary view see Bajada above n 161, 12.

legislative reform¹⁸⁴ and the ATO's tax compliance (anti-avoidance) strategies.¹⁸⁵ As a result, the studies tend to focus on the savings of particular measures rather than the impact upon the system as a whole. A further problem in measurement is the absence of a clear line between tax avoidance and tax evasion (discussed earlier), which means that it is difficult to come up with a clear and objective measurement.

3 The use of prevention of tax avoidance and evasion within the thesis

From the above it is clear that many of the more recent reports and inquiries see the prevention of tax avoidance and evasion as a separate tax policy aim of a good tax system. Again the issue is how best to use it in the context of the thesis.

Given the legal focus of this thesis, the existence of opportunities for tax avoidance or evasion in the legal rules relating to residency and source will be illustrated qualitatively through identifying instances where there appear to be evasion or avoidance opportunities. Similarly, in the reform context, the focus will be upon review of alternatives that limit the scope for evasion or avoidance opportunities.

IV. Justification for the adoption of the four tax policy objectives

From the above analysis, it is clear that the four evaluative tests as defined are appropriate tests for evaluating the effectiveness of the law relating to residency and source. However, there are a number of other tax policy objectives identified in the various reports and inquiries that could also be used in evaluating the adequacy of the law of residency and source in its practical application. Therefore, it is important to

184 Malcolm Gammie, 'Tax avoidance and the rule of law: A perspective from the United Kingdom' in Cooper (1997), above n 43, 181, 212 notes that the legislative response tends to target the symptoms of the problem rather than the underlying cause. This response is common as they are seen as inequitable and a threat to the revenue - eg Ligertwood Committee, above n 7, xiii.

Thus, tax avoidance and tax planning arrangements are attacked under the specific anti-avoidance provisions (there are still in excess of 500 such provisions) and by the general anti-avoidance provision (Part IVA of the 1936 Act). This trend continues. The ATO warns in NTLG minutes 2 September 2003, above n 178, Item 2, that where "aggressive tax planning" arrangements do comply with the law, including Part IVA of 1936 Act, and the ATO believes that they are contrary to the policy intent of the law, the matter would be referred to Treasury for consideration of a policy response. International tax avoidance and tax evasion is being targeted through bi-lateral exchange of informational agreements and OECD attacks on foreign secrecy laws.

185 Tax evasion has been principally dealt with through audit and enforcement action by the ATO (see ATO Compliance Plans - Australian Taxation Office, Commonwealth, *Compliance Plan 2004-05* (2004)) supported by legislative changes focused on enhanced registration and identification

review the key alternative tax policy objectives in order to further justify why the four tax policy objectives chosen are the most appropriate in the context of the hypotheses. The following is an evaluation of the key alternative tax policy objectives.

A. Revisiting the jurisdictional claim

From a policy perspective, it is preferable to undertake a fundamental evaluation of Australia's taxation jurisdictional claims, than to adopt piecemeal solutions. As Abreu notes:

[i]t would be nice if we could stop reacting to problems in the tax system by attempting to design new and improved Band-Aids and could turn instead to a comprehensive examination of the structural features of the system that cause the problem to arise in the first place.¹⁸⁶

To ensure such a fundamental evaluation of Australia's taxation jurisdictional claims it is necessary first to clearly articulate what is the scope of that claim, before comparing it with the existing claim.

For example, in evaluating residency rules applying to individuals, consideration must be given to determine who should be a resident and who should not. The possible range of persons who could be residents include:

- Australian citizens and permanent residents;
- other persons who live in the jurisdiction for a period and receive the benefits of that jurisdiction (visitors, long and short stay);
- persons who receive income from a jurisdiction for personal service performed on behalf of that jurisdiction (Australian employees posted abroad);
- persons who earn income from wealth originally amassed in the jurisdiction; or
- even persons who hold property in a jurisdiction or derive income from such property.

Who is ultimately included as a resident will also depend upon economic and social value judgments. Further, any analysis of residency solutions may also consider in

systems (eg the Tax File Number (TFN) System and the Australian Business Number (ABN) System). Also see ANTS, above n 1,150.

tandem the impact of possible changes to the source concept and international developments around DTAs in light of international concerns about the impact of the Internet.¹⁸⁷ It is only with this policy articulation that simple, equitable and efficient residency and source rules can be designed.

However, despite the perceived merits of such an approach there appears to be resistance to such a jurisdictional rearticulation.

1 *Current resistance to jurisdictional articulation*

From a practical view, the experience of reform process in other jurisdictions where individual residency rules have been reviewed (the United States (1984), New Zealand (1988), the United Kingdom (1993) and Ireland (1994))¹⁸⁸ is that there has not been a

186 Alice Abreu, 'The difference between expatriates and Mrs Gregory - Citizenship can matter' (1995) *Tax Notes International* 1613, 1615.

187 The ATO argues that the challenges are not unique to Australia and the solutions lie with treaty partners and international forums such as the OECD - ATO's first Internet Report, above n 12, vii.

188 United States: Prior to the introduction of the *Deficit Reduction Act 1984* (US) residency in the United States was determined by reference to a person's individual facts and circumstances. The test was too difficult to administer, there was abuse by non-resident green card holders and resident aliens were outside the United States tax net - see Leonard Rothschild Jr and Michael Schinner, 'United States: Determining Residency for Federal Income Tax Purposes' (1993) 47 *Bulletin for International Fiscal Documentation* 85, Denis Sheridan, 'Residence in the United Kingdom: Observations on the Inland Revenue Consultative Document' (1988) 29 *European Taxation* 17, 28 and Michael McIntyre, *The International Income Tax Rules of the United States* (2nd ed, 1992) 1-21.

New Zealand: As the ability to manipulate the existing tests would undermine the Branch Equivalent and trust regimes being recommended by the New Zealand Consultative Committee on International Tax Reform and Full Imputation it also recommended that the test should be amended (see New Zealand, Consultative Committee on International Tax Reform and Full Imputation, *Second Report* (July 1988) para 2.4). A revised residency test s 241 was introduced by the *Income Tax Amendment Act (No 5) 1988* (NZ) based on the Committee's recommendation. The s OE1 is a restatement of the revised s 241(1)-(5) of the *Income Tax Act 1976* (NZ). For further discussion see Garth Harris, *New Zealand's International Taxation* (1990), 8-9.

In the United Kingdom the major reviews were the:

- 1936 *Income Tax Codification Committee* (above n 13) para 59. The Committee criticised the uncertainty in the law and implied that it had been maintained uncertain to benefit the Revenue - see Denzil Davies, *Booth: Residence, Domicile and UK Taxation* (1995), 167;
- 1955 Royal Commission (above n 13). The Commission recommended that legislation should be passed to codify as far as practicable the working rules for residence and ordinary residence - see Sheridan, above n 188, 22, 25 and John F Avery Jones et al, 'Dual Residence of Individuals: the Meaning of the Expression in the OECD Model Convention - I' [1981] *British Tax Review* 15, 106;
- 1974 UK Inland Revenue review of 'ordinary residence' - see *Finance Bill 1974*, Explanation note on cl 18 (Foreigners Living in the UK for substantial periods) cited in Peter Whiteman et al (eds), *Whiteman on Income Tax* (3rd ed, 1988), 136;
- 1993 bill to amend the domicile law (withdrawn 26 May) - see Constance McCarthy (ed), 'United Kingdom: Law of Domicile' (26 July 1993) *Tax News Service* 267;
- 1997 report of Joint Report of the Law Commission and the Scottish Law Commission (*Private International Law: the Law of Domicile* Law Comm No 168; Scot Law Com No 107 (September 1997)). Commission recommended changes to the law of domicile; and

clear policy articulation of jurisdictional claim. Rather, Governments have tended to focus on solutions to specific problems identified by introducing more objective rules to deal with the problems encountered.¹⁸⁹ The one exception is the 2003 United Kingdom review of residence and domicile rules, which has sought to develop fundamental principles to underpin any change.¹⁹⁰

A similar outcome has been experienced in Australia. The 1997 consultant's report, prepared for the ATO's Electronic Commerce Project, only made piecemeal recommendations in respect of the residency rules.¹⁹¹ Similarly, in the 1999 Review of Business Taxation, in its final report, *A Tax System Redesigned*,¹⁹² despite its recommendations for international tax reform¹⁹³ (in particular in respect of statutory source rules) and its recommendations in respect of an integrated tax design process,¹⁹⁴ failed to put fundamental reform of the "basic building" blocks of Australia's tax system (residency and source) specifically on the agenda. Finally, in 2002 the *Review of International Taxation Arrangements* failed to even pick up the source rule recommendations let alone undertake any fundamental review.¹⁹⁵

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- UK Inland Revenue, Consultative Document, *Residence in the United Kingdom: The Scope of the United Kingdom Taxation of Individuals* (July 1988). Although the document recommended changes to the individual residence rules, the document was attacked for being driven by considerations of administrative ease rather than the good law criteria and fundamentally misstating the operation of the law (Sheridan, *ibid*) and failing to address treaty concerns (John Avery Jones, 'Aspects not covered by the Consultative Document on Residence' (1989) 29 *European Taxation* 39).

Ireland: In 1993 the Revenue Commissioners initiated the review of the residency tests (see generally Charles Haccius, *Ireland in International Tax Planning* (1995) 64). Ireland had five separate residency tests: four "resident" tests (the common law "the place of abode" and "substantial and habitual presence" tests and the statutory six month, and intention to reside tests (under s 206 of the *Income Tax Act 1967* (IRE) (ITA 67)) and the common law "ordinary resident" test (see further Willie McAteer and George Reddin, *Income Tax* (1981) 202). The Community responded (see, eg, Institute of Taxation in Ireland, *1993 Pre-Budget Submission to the Irish Minister for Finance* (14 December 1993) and Gearoid Griffin, President of the Institute of Taxation in Ireland, *Submission to the Irish Minister for Finance concerning proposed changes to Ireland's residency laws for individual*, (5 May 1994)), with changes via the *Finance Act 1994*, s 149.

189 For example, despite five major reviews in the United Kingdom (see above n 188) only a minor change has occurred in 1993, being the incidental work exclusion to the "place of abode test" being introduced via s 208 of the *Finance Act 1993* (UK). Similarly, Ireland (via the *Finance Act 1994*, s 149) merely adopted new objective tests for "resident" and "ordinary resident" individuals for purposes of the Income Tax Acts, the Corporation Tax Acts, the Capital Gains Tax Acts, and the *Capital Acquisitions Tax Act 1976*.

190 2003 UK Review of residence and domicile rules, above n 13.

191 Alan Tyree, et al, *Computer Money Consulting Pty Ltd 's INNET 97/2 Report on Electronic Commerce Banking and Finance Issues* (1997) at URL: <http://www.ato.gov.au/content/Businesses/Downloads/cmc.rft>, Part 2 as at 31 December 2002. The report has subsequently been removed from the ATO site.

192 *A Tax System Redesigned*, above n 10.

193 *Ibid*, Recommendations 22.18 to 22.24 and 23.1 to 23.3.

194 *A Tax System Redesigned*, above n 10, Recommendation 1.1.

195 Treasury Consultation Paper (2002), above n 11 and Board of Taxation, above n 11.

2 Evaluating the resistance

The reasons are not evident for why these reports and reviews have pursued the pragmatic, yet piecemeal approach of concentrating on single issue solutions rather than encouraging fundamental reflection and change.¹⁹⁶ This is particularly puzzling in respect of the 2002 Review of International Taxation Arrangements' *Consultation Paper* given the views of the Review of Business Taxation in its *A Strong Foundation*¹⁹⁷ paper that:

[t]he rules governing business taxation are the result of an accelerating accretion of policy changes over several decades. This process of unstructured accretion has increased the complexity of changes and limited their effectiveness. While each policy change, or program of changes, has been designed to address particular problems, those policy changes are now revealed to have been additions to a system lacking a sound foundation.

The solution may simply be that the task is now just too hard, complex and costly. In reality, such change is always a combination of economic and social value judgments, which are not easily evaluated through legal analysis. Further, any analysis of any solutions must also consider in tandem the impact of possible changes to the source concept and international developments around DTAs in light of international concerns about the impact of the Internet.¹⁹⁸

3 Use within the thesis

The fundamental evaluation of Australia's taxation jurisdictional claims is not feasible within the scope of this thesis, which is focused upon evaluating the existing legal rules within the jurisdictional claim. Thus, the approach in the thesis is to undertake legal analysis in terms of the narrow jurisdictional claim inherent in Australia's current residency and source rules and to evaluate any reform proposals in light of the jurisdictional limitations.

196 Examples where specific fixes have been pursued rather than considering alteration to the residency rules are:

- the removal for some foreign employed taxpayers questions of cessation of residency via the introduction of s 23AG of 1936 Act (see Chapter 3, Part II, B, 1); and
- the countering of concerns about avoidance of capital gains tax on assets that have "necessary connection with Australia" due to change in residency by reserving the right under s 104-160(3) of 1997 Act to tax persons on capital gains on assets either when they become non-resident or upon later disposal of assets (see Chapter 3, n 267).

197 *A Strong Foundation*, above n 27, 14.

B. Consistency with the policy reasons for its introduction

The adoption of consistency with the policy reason as an evaluative tool on the face of it seems logical, as if the law is consistent with the tax policy the law must be sound. Further, in more recent times the policy can be found in the explanatory memorandums to taxation bills and the various parliamentary debates.¹⁹⁹

1 Difficulties in use of the “consistency with introduction policy” approach

However, there are two fundamental problems with using this objective in the context of this thesis. First, consistency with the policy does not necessarily mean the law is sound. If the policy is developed for other than tax reasons, such as social welfare,²⁰⁰ then the resultant law may not be a good tax law.

The second problem is it is often difficult to identify the policy underlying a law because:

- the law, which was enacted a long time ago, was rarely accompanied by detailed secondary material (such as explanatory notes) that articulates the underlying policy;
- recently developed laws also sometimes lack clear underlying policy, as the principle policy reasons are often diluted or compromised due to concessions granted in the political process; or
- the underlying policy is implicit.

198 The ATO argues that the challenges are not unique to Australia and the solutions lie with treaty partners and international forums such as the OECD - ATO's first Internet Report, above n 12, vii.

199 Since 1981 the *Acts Interpretation Act 1901*, s 15AA directs the courts in interpreting a provision to give it the construction which favours the purpose of the legislation and s 15AB which indicates what information and what documents should be looked at to determine what was the purpose of the legislation. These amendments were introduced to overcome the literal approach to interpreting tax legislation, (ie taxpayers will be taxed on form of transaction not its substance) adopted by the courts - see *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1 and *Slutzkin v Federal Commissioner of Taxation* (1977) 7 ATR 166; 77 ATC 4076. Following the announcement of the legislation the High Court in *Cooper Brookes (Wollongong) v Federal Commissioner of Taxation* (1981) 147 CLR 297; 11 ATR 949; 81 ATC 4292 stated that they would repair a literal defect where it would give rise to an improper result (ie application of the Golden rule).

200 Examples are the politically astute 2001 election proposals in respect of a first child tax rebate (see *Taxation Laws Amendment (Baby Bonus) Act 2002* (Cth)) and family tax benefit measures. Both the social policy measures add complexity to the tax law in a number of ways, are arbitrary and impose additional compliance costs.

An example of obscure policy in older legislation is the absence of explicit reasoning behind the adoption of the source basis of taxation in most Australian colonies ahead of residency based taxation. As explained in Chapter 1, although a world wide basis of taxation was adopted in Australia's first colonial income tax law, introduced in Tasmania in 1880, the income tax systems introduced by the Commonwealth and the other Australian States/colonies were founded on source rather than residency.²⁰¹

From the Committee debates in the Tasmanian House of Assembly on the failed *Income Tax Bill 1866* (Tas), it is clear that residency was the preferred option.²⁰² The reason for adoption of residency in Tasmania was that to tax only domestic sourced income would create incentive to shift income offshore.²⁰³ As a result, the world wide basis for taxing income was adopted in the failed *Income Tax Bill 1873* (Tas),²⁰⁴ in the failed *Income and Property Tax Bill 1879* (Tas),²⁰⁵ in the *Real and Personal Estates Duty Act 1880* (Tas), in Tasmania's first general income tax Act (*Income Tax Act 1894* (Tas)),²⁰⁶ and in subsequent Acts.²⁰⁷

This lead was not followed in other colonies, or (later) the Commonwealth, despite residency being adopted in New Zealand in the 1890s.²⁰⁸ For example, the Victorian Legislative Assembly debates on the *Land and Income Tax Bill 1894* (Vic) indicate that the issue of taxing foreign source income was discussed twice on 13 December 1894, and despite the world wide basis taxation models in Tasmania, New Zealand and the

201 Chapter 1, 6 and n 41.

202 Clause 3 of the Bill was amended to expand the scope of the Bill from source based taxation to taxing the foreign source income of residents - *The Mercury* 30 August 1866 - cited in Peter A Harris, *Metamorphosis of the Australasian Income Tax: 1866 to 1922* Research Study No 37, Australian Tax Research Foundation (2002), 31.

203 *The Mercury* 11 October 1873 cited in Peter Harris, *ibid*, 36.

204 Clause 3 of the Bill was amended to ensure that “. . . where any person residing in Tasmania derives any income from sources out of Tasmania” it would be taxed. To avoid double tax, the clause provided that such income would be exempt to the extent income tax had been paid in England or elsewhere - *The Mercury* 11 October 1873 cited in Peter Harris, *ibid*, 36.

205 *The Mercury* 17 May 1879 cited in Peter Harris, *ibid*, 59.

206 *Income Tax Act 1894* (Tas) s 14 imposed a “. . . tax on all income arising, accruing, received in, or derived from Tasmania.”

207 See, eg, *Income Tax Act 1902* (Tas) s 14, and *Land and Income Taxation Act 1910* (Tas) s 27. In all these subsequent Acts relief from any potential double taxation was provided for by permitting any taxpayer residing in Tasmania in receipt of foreign source income, to deduct from the income tax payable in Tasmania any income tax paid in respect of that foreign income derived in England or elsewhere (see, eg, 1894 Act, s 29, 1902 Act, s 52 and 1910 Act, s 114).

208 See, eg, the failed 1876 Victorian *Land, Property, and Income Tax Bill* (Vic) – Peter Harris, above n 205, 41. Residency was adopted in New Zealand - see *Land and Income Assessment Act 1891* (NZ) and *Land Tax and Income Tax Act 1892* (NZ). The failure to adopt residency is harder to understand given that all the Governments start with the 1842 United Kingdom Act as their model (Harris, *ibid*, 65, 80)

United Kingdom being mentioned, no amendment was made to alter the source only basis of the Bill.²⁰⁹

Although it is unclear why most of the Australian colonies and later the Commonwealth adopted the source model, it is possible to elicit a number of reasons, which appear to have played a role in the adoption of the source basis of taxation.

First, a possible reason was that ". . . there were virtually no Australian taxpayers who received an income from investments or business abroad."²¹⁰ This view has some support in the recommendations of the 1920 Royal Commission on Taxation,²¹¹ which qualified its recommendation for the adoption of residency based taxation by stating:

[i]f the financial requirements prove to be such that the raising of additional revenue through taxation is unavoidable, then, in preference to a general increase of income Tax rates . . . we recommend resort to the taxation of incomes derived abroad.

A second possible reason was a belief that ". . . apart from the question of revenue production, the practical disadvantages . . . outweighs the advantages" of a residency based system.²¹² The difficulties cited by the 1920 Royal Commission on Taxation,²¹³ included that a residency based system would create additional complexity (due to double taxation arising from the states adopting such a system) and that the taxes on resident's foreign income would be an impediment to foreign investment.

The actual reasons for the source basis being adopted are probably a combination of the above factors (ie the additional revenue from adopting the residency basis did not outweigh the difficulties in adopting that basis). Ultimately, it was the need for revenue that forced the change²¹⁴ and gave rise to a residency basis of taxation in Australia.

209 Victoria *Parliamentary Debates/Legislative Council and Legislative Assembly* (1866-1958), Vol 75, 1018, 1019 and 1115 cited in Peter Harris, *ibid*, 138-9.

210 Seligman (1928), above n 13, 47.

211 1920 Royal Commission, above n 4, 108.

212 *Ibid*, 107.

213 *Ibid*, 108.

214 The emergence of income tax emerged in the Australian colonies and states (and ultimately its adoption by the Commonwealth) can be traced to the need to fund government deficits as the result of expansion (Tasmania and South Australia), the collapse of banks and the resulting financial crisis in the 1890's (New South Wales and Victoria), the removal of tariffs (Queensland and Western Australia) and a war (the Commonwealth). Also see the 1932 Royal Commission n 5, 65.

A further problem is that in making its conditional, majority recommendation, the 1920 Royal Commission did not consider how residency was to be implemented.²¹⁵ Even in 1927 when the Commonwealth made the decision to adopt a residency basis of taxation, the actual form of the test was not discussed. Thus, there was no clear articulation of Australia's taxation jurisdictional claims (ie no consideration was given to determine who should be a resident and who should not). So, the rules introduced in 1930 and 1939 were developed in isolation by the bureaucracy with no clear theoretical articulation.

Even in more recent times, determining the policy can be difficult as the formation of a tax system (tax policy) is essentially a political process, with change generated from the arenas of politics, philosophy, ideology, economics and sociology.²¹⁶ These arenas drive the tax policy debate on issues such as complexity, compliance costs, the tax mix (direct (income) taxes verse indirect (consumption) taxes verse wealth and transfer taxes) and effective tax rates.²¹⁷ Thus, given these competing forces it is often difficult to find a single underlying policy. The problem can be summarised as:

. . . virtually everything government attempts to do with direct expenditure programs they also attempt (for better or for worse) to do with tax policy. Today, tax and spending issues cannot be neatly separated into the categories of "who gets what" and "who pays for it." A modern tax system is a complex mix of both payments and benefits.²¹⁸

The final problem is that even if a stated policy is found in supporting documentation there may often be little comfort. Due to the process discussed above, the stated policy may not reflect the range of related policies which underlie the final policy position.

In summary, the difficulty in determining the policy underlying a law arises as

[t]here is no country in which the whole system of taxation is one, logically worked out from the first principles. Everywhere the accidents of political

215 1920 Royal Commission, above n 4, 108.

216 See, eg, John Wilkes (ed), *The Politics of Taxation* (1980), Sven Steinmo, *Taxation and Democracy - Swedish, British and American Approaches to Financing the Modern State* (1993) and Waincymer, above n 23, 1-39.

217 For example Alan J Auerbach, 'Tax Reform, capital allocation, efficiency, and growth' in Aaron, above n 152, 29.

218 Steinmo, above n 216, 1.

and commercial considerations in past history are perpetuated, and condition the present system.²¹⁹

Thus, if the policy is not clear then the consistency level is hard to measure. Even where consistency with policy exists, for the reasons mentioned above, it does not prove that the policy is a good tax policy. However, although consistency with policy itself may not be an evaluative tool, departure from policy may be indicative of why the law is not effective.

2 Use within the thesis

On balance, consistency with policy may not always assist in evaluating the effectiveness of a tax law as illustrated by the examples set out above. However, where the policy underlying the source or a residency rule is evident, and the law does not reflect that policy, then this outcome will be highlighted in the thesis.

C. Consistency with national or governmental economic objectives (fiscal strategies); ensuring economic growth; and providing for an international competitive economy

The three policy objectives (as named above) are related to efficiency and have been used in many reports as a focus for reform. Each tax policy objective will be briefly defined and the measurement issues briefly examined before their use within the thesis is addressed.

1 Consistency with the Government's fiscal strategy

Consistency with the Government's fiscal strategy has been used as a policy objective in some reports.²²⁰ The policy objective is simply - are the "reform proposals framed in a manner consistent with the Government's fiscal strategy"? There is a rider that the proposal may not be required to meet the objective if there is a good reason.

Consistency with fiscal strategy is a practical barometer for identifying areas for reform. However, as with the consistency with government policy (discussed above), although

219 Sir Josiah Stamp, *The Fundamental Principles of Taxation in the Light of Modern Developments* (1936), 25.

220 1996 FSI Paper, above n 12, 19.

the fact that a law is consistent with the Government's fiscal strategy may indicate fulfilment of the Government's policy, it is not by itself a tax policy objective that can be used to evaluate the effectiveness of a tax law. Further, as fiscal strategies change in response to changing economic conditions and the changing social strategies of political parties in power, the test is only relative at the time the measure is introduced. Thus, as the main thesis is exploring the effectiveness of the law within existing jurisdictional claims then it is possible that measures introduced in the 1890's will be inconsistent with the current fiscal strategy.

In light of the above discussion and given the legal focus of the thesis, the "consistency with the Government's fiscal strategy" objective is not an appropriate measure, and will not be adopted in the thesis.

2 International competitiveness (which involves countering international tax competition)

International competitiveness is used as a tax policy objective in a number of reports and inquiries. The policy objective is that:

the tax system should recognise the challenge of (international) tax competition and maximise the opportunities for broader microeconomic reform efforts to contribute to an internationally competitive economy.²²¹

It is claimed that a competitive tax system enhances business activities by encouraging relocation in Australia, enhances employment prospects, and increases standards of living.²²²

In order to achieve this goal the suggested solutions involve abolishing inefficient and distorting taxes, removing taxes on business inputs and exports, encouraging productive investment, reducing tax avoidance and evasion, reducing complexity, reducing compliance costs²²³ and ensuring "that business decisions are not unduly constrained by the business tax system."²²⁴ An internationally competitive economy requires, and is

221 Ibid. Also see 2003 UK Review of residence and domicile rules n 13, 1.

222 Australian Chamber of Commerce and Industry (ACCI), *Australia's Tax System and International Competitiveness* (1993), 2.

223 Fightback, above n 14, 3; ACCI, *ibid*, 3 and 5; and ANTS, above n 1, 156.

224 Board of Taxation, above n 11, 31.

sustained by, the efficient use of its economic resources.²²⁵ Thus, many of the measures and solutions appear to be underpinned by the objectives of efficiency, simplicity and the prevention of tax avoidance and tax evasion. As satisfaction of these objectives gives rise to a competitive economy, then the major reason for adopting “international competitiveness” as a stand alone policy objective is political, rather than tax policy.

Further, the measuring of international competitiveness requires extensive economic modeling of a number of economies. There are also difficulties in measuring changes in international competitiveness arising from changes in discrete rules such as the law relating to residency and source.

Again, in light of the above discussion, the doctrinal legal focus of the thesis, and the focus of the thesis on the domestic operation of those laws, international competitiveness is an incompatible policy objective.

3 Economic growth

A number of reports cite economic growth as a policy objective of the tax system.²²⁶ This objective seems to fall outside the traditional tax policy objectives²²⁷ as the objective has been seen as merely an outcome affected by the efficiency effects arising from neutrality.²²⁸ However, in many other cases these words have often been used in the taxation context as euphuisms for advocating lower taxes.²²⁹

In the 1998 ANTS paper, the Treasurer conceded that it is difficult to measure economic growth. The Treasurer noted, however, that measurement is possible and has been theoretically shown by a range of studies.²³⁰ The modeling conducted to demonstrate the benefits of the proposed tax changes, involved the use of the Treasury’s Price Revenue Incidence Simulation Model (PRISMOD), which is a large scale, highly disaggregated model of the Australian economy. PRISMOD models 107 industries purchasing 1200

225 Ibid.

226 See, eg, Asprey Report, above n 8, 17; McCaw Report, above n 26; A Strong Foundation, above n 27, 62 and a Tax System Redesigned, above n 10, 13.

227 Fisher, above n 23, 62.

228 A Strong Foundation, above n 27, 75.

229 Asprey Report, above n 8, 17. See claims in ANTS, above n 1, 156.

230 See claims in ANTS, above n 1, 153-202.

inputs. Further, there are potential conflicts between economic growth and price stability and equity.²³¹

Given the complex nature of the measurement methodology, it would be impossible to use this objective in the context of a legal, doctrinally based thesis.

D. Miscellaneous policy objectives – harmonisation, standardisation, inflation, and depreciation

As a result, not all the policy objectives used in the reports are relevant as they are issue specific (eg focusing on inflation,²³² double taxation²³³ or depreciation²³⁴) or are focused upon harmonisation (uniformity or standardisation) of specific tax laws of different jurisdictions.²³⁵ Further, as the thesis is a legally focused study, many of the objectives (in particular those that have an economics basis) may be inappropriate given the general measurement approach.²³⁶

E. Summary

All the additional tax policy objectives discussed above are useful in measuring the effectiveness of a tax law. However, for the reasons discussed above they in general will not be used within the thesis. The one exception is where the policy underlying the source or a residency rule is evident, and the law does not reflect that policy. Where this occurs this will be highlighted in the thesis.

231 Carter Commission, above n 13, Vol 2, 41-5 and 47-8 and McKerchar, above n 120, 24-36.

232 Committee of Inquiry into Inflation and Taxation, Commonwealth *Inflation and Taxation* (1975) (Mathews Report), 1985 Draft White Paper, above n 9, 16 and United Kingdom, *Report of the Inflation Accounting Committee: Inflation Accounting* Cmd 6225 (1975).

233 1932 Royal Commission, above n 5, 65-78, Bruins, above n 13, Stamp, above n 219, 130-42 and Seligman (1928), above n 13.

234 Commonwealth Committee on Rates of Depreciation, Commonwealth, *Report* (1955).

235 1920 Royal Commission, above n 4, 3; 1932 Royal Commission, above n 5, 5; 1937 NSW Taxation Investigation Committee n 115, 1; and 1985 Draft White Paper, above n 9, 17.

236 For example the factors in economic allegiance (acquisition, situs, enforceability and domicile) used by Bruins, above n 13 are not appropriate evaluative tools in the context of this thesis given its focus on legal aspects. For similar reasons the use of tax policy objectives such as “tax distributions (ie the tax burden), as used in UK 1953 Royal Commission on the Taxation of Profits and Income, above n 13, would be of little relevance as is the pure economic theory approach adopted in New Zealand, Tax Review 2001, *Final Report* (2001) (McLeod Report), at URL: <http://www.treasury.govt.nz/taxreview/2001/> located on 31 December 2003.

V. Conflict between the tax policy objectives

The final issue, having defined the policy objectives to be used in the thesis, is how to give weight to the relative importance of each of the four policy objectives in evaluating the effectiveness of the law relating to residency and source and in evaluating reform options.²³⁷ This issue is crucial given that many of the objectives operate inconsistently, give rise to conflicting policy directions²³⁸ (as various tax rules serve different policy aims²³⁹) and are unable to provide definitive policy guidance.²⁴⁰ Thus, the more one tax policy objective is satisfied the less another may be adequately realised, for example:

adopting a particular tax provision might increase the rate of economic growth. However, the same provision might also reduce the fairness of the system by providing some group of individuals with a tax advantage relative to others in the same circumstances.²⁴¹

Ultimately the most appropriate balance adopted will arise from a compromise being struck between often unavoidable conflicts between the policy objectives.²⁴² The first step is to identify the areas of conflict.

A. Identifying the conflicting policy objectives

The Asprey Report identifies three key areas of where policy objectives conflict: simplicity and efficiency, or equity (fairness) and simplicity or equity (fairness) and efficiency.²⁴³ Conflict can also occur with the anti-avoidance policy objective. Thus, policy makers have to choose, in deciding between alternative provisions, which objective has precedence.²⁴⁴ The following looks at the conflicts to determine which should have precedence.

237 A Strong Foundation above n 27, 65.

238 Carter Commission, above n 13, 3.

239 Asprey Report, above n 8, 20.

240 Downing, above n 14, 48 after noting the conflicts recommend any changes based upon economic efficiency should only be made having examined the possible effects on income distribution. Also Couzin, above n 138, 494 suggests that the cause of much complexity is the competing objectives of the tax system, which affect tax policy, the legislation and its administration.

241 Carter Commission, above n 13, 3.

242 The Asprey Report, above n 8, 12 and 1985 Draft White Paper, above n 9, 14

243 Asprey Report, above n 8, 12 and 1985 Draft White Paper, above n 9, 14.

244 A Strong Foundation, above n 27, 66, notes that different Governments give different weight to equity and efficiency.

1 *Simplicity and efficiency/neutrality*

Although conflict does arise between the tax policy objectives of simplicity and efficiency/neutrality, that conflict is not great as efficiency/neutrality is achieved through a comprehensive tax base (a simple, broad-based tax with uniform rates).²⁴⁵ However, as changes to economic efficiency will have impacts upon the distribution of income (vertical equity), any changes should only be made after considering those impacts.²⁴⁶

2 *Equity and simplicity*

The conflict between tax policy objectives of equity and simplicity is the hardest to resolve as equity is based upon individualising the tax system to deal with an individual's multitude of different situations, which in turn gives rise to the most complex taxes (income tax, capital gains tax, gift and estate duties, and wealth taxes).²⁴⁷ This greater complexity may result in a decline in knowledge about and understanding of the law, placing in jeopardy "individual rights and liberties."²⁴⁸

Given this apparent irreconcilable conflict the Asprey Committee concluded "that a country may have a simple and efficient taxation system or an equitable one but not both."²⁴⁹

3 *Equity and efficiency*

The tax policy objectives of equity and efficiency/neutrality can also conflict. For example, measures, which make the system more equitable, often require complex legislative provisions, which in turn may also cause economic distortions.²⁵⁰ However, there is not always a trade off between equity and efficiency.²⁵¹ For example, horizontal equity is integral in achieving efficiency in minimising any distortions in commercial

245 Asprey Report, above n 8, 20, Simons, above n 43, 158 and A Strong Foundation, above n 27, 75.

246 Downing, above n 14, 48.

247 Asprey Report, above n 8, 21.

248 Carter Commission, above n 13, 3.

249 Asprey Report, above n 8, 21.

250 1985 Draft White Paper, above n 9, 14.

251 Yuri Grbich, Adrian Bradbrook and Kevin Pose, *Revenue Law: Cases and Materials* (1990), 40.

choices.²⁵² Further, sometimes pursuit of efficiency can create additional complexity and create a greater risk for abuse.²⁵³

4 Prevention of avoidance and simplicity, equity and efficiency

The tax policy objective of prevention of tax avoidance often conflicts with simplicity, as the specific and general anti-avoidance measures can create complexity and uncertainty. However, the “prevention of tax avoidance” objective complements both equity²⁵⁴ and efficiency by ensuring both vertical and horizontal equity objectives are met and by minimising distortions in investment decisions.

B. Weighting the objectives

Having identified the areas of conflict, there are two methods of attack: to avoid the conflict or to seek some form of compromise based upon weighing up and assigning relative values to each policy objective.²⁵⁵

1 Avoiding conflicts

The easy way to overcome conflict in tax policy objectives is to avoid the conflict. This can be achieved by looking at alternative methods, which do not have the unwanted negative effects on other objectives. For example, “the negative effects of an otherwise desirable tax provision on an objective can often be compensated for by introducing or changing other tax provisions.”²⁵⁶

2 Choosing between the objectives where there is unavoidable conflict

Where conflicts between tax policy objectives are unavoidable the only solution is compromise. Any compromise, however, involves an evaluative process, which involves

252 2002 Consultation Paper n 11, 84.

253 As mentioned above (n 83) the active income exemption for the CFC rules was introduced to promote capital import neutrality. Paul J Keating, Commonwealth, *Taxation of Foreign Source Income: An Information Paper* (1989), 6 notes that most countries accepted the increased complexity and avoidance risk when formulating a tight active income exemption.

254 Above n 27 and quote in text from Carter Commission.

255 Asprey Report, above n 8, 20.

256 Carter Commission, above n 13, 4. Also see David J Collins, ‘Designing a tax system for Papua New Guinea’ (1985) 2 *Australian Tax Forum* 327, 331.

knowledge of the trade offs. This involves estimating “the extent to which one objective will be sacrificed if another is to be realised more completely; and the relative importance attached to the competing objectives.”²⁵⁷

Any weighting of tax policy objectives will be value laden and in the end “we have to accept in the last resort pragmatism is likely to prevail over economic principle, perceived political rationality over economic rationality,”²⁵⁸ and assign the relative weightings to each policy objective.

However, despite supporting a greater weighting for a range of tax policy objectives,²⁵⁹ traditionally equity is domestically the tax policy objective given the greatest weighting by many of the reports and enquiries.²⁶⁰ The reasons are twofold.

First, it is argued that equity underpins the tax system. The Carter Commission argues that as tax transfers command over goods and services from individuals and families to the state:

[i]f equity were not of vital concern taxes would be unnecessary. The state could simply commandeer what it needed. The burden of a reduced private command over goods and services would then be borne by those individuals and families who happen to be within the reach of the state.²⁶¹

Second, as seen from previous discussion, a failure to deliver an equitable tax system can work against other tax policy objectives such as prevention of tax avoidance and simplicity. A lack of equity can weaken “the social and political fabric of a country” as taxpayers seek to evade their taxes, resulting in high enforcement costs.²⁶²

257 Carter Commission, above n 13, 3.

258 Cynthia Coleman, ‘Why Tax Systems Differ’ (2001) *Australian Tax Forum* 411, 413 citing Cedric Sanford, *Why Tax Systems Differ* (2000).

259 See, eg, A Strong Foundation, above n 27, 66, which recommend more weight be given to simplicity.

260 See, eg, Carter Commission, above n 13, 4 and A Strong Foundation, above n 27, 63. However over the last 20 years there appears to be a greater emphasis on efficiency than equity in many countries – see Field, above n 53, John Head, ‘Tax Reform: A quasi-constitutional perspective’ in Cooper (1997) above n 43, 155, 179, and Graetz (2001), above n 34, 1363.

261 Carter Commission, above n 13, 4.

262 Ibid. Graetz (2001), above n 34, 1394-98 and 1406 argues that equity is also a crucial objective for international tax policy.

C. Balancing the objectives in the thesis

From the above it is clear that any ranking of the criteria is open to challenge, as it is dependent upon a whole series of competing values. Further, while some of the tax policy objectives compete, others complement each other (horizontal equity and efficiency) or could be a facet of another (administrative efficiency and simplicity). However, it does appear that of the four tax policy objectives equity is seen as fundamental.

Given the doctrinal legal focus of the thesis, the approach adopted in the thesis, where it is demonstrated that one or more of the four tax policy objectives are not met (or they are in conflict), is that the equity policy objective will have primacy in evaluating the adequacy of the law and the reform options. However, where the equity objective leads to negative outcome in terms of simplicity (complexity) and tax avoidance, the reform option that will prevail is that which provides a balance between the equity tax policy objective and the simplicity and anti-avoidance tax policy objectives.

VI. Conclusion

The thesis seeks to distill the scope of the jurisdictional claim from the current residency and source rules. It also seeks to recast the existing rules in a way that jurisdiction is preserved but the resultant rules are more consistent with the four tax policy objectives identified (ie that the law can be modified within the jurisdictional framework to more closely meet that objective).

The approach adopted for each of the tax policy objectives used to qualitatively evaluate the effectiveness of the law of residency and source is set out in the following.

A. Equity

The equity of the legal rules relating to residency and source will be evaluated in the thesis by identifying when the law does not in certain circumstances give rise to either horizontal or vertical equity. Thus, the thesis will highlight where individuals in similar

circumstances are not being taxed similarly or where the tax burdens do not fall upon those with the greatest ability to pay.

Similarly when focusing on reform of the legal rules relating to residency and source, reform recommendations will also be measured by illustrating where the proposed reforms result in changes that ensure that individuals in similar circumstances will be taxed similarly or where the tax burdens fall upon those with the greatest ability to pay.

B. Efficiency

The lack of efficiency (neutrality), if any, in the legal rules relating to residency and source will be evaluated qualitatively by identifying when the law in certain circumstances gives rise to distortions such as a taxpayer being taxed differently due to the market in which the taxpayer operates (eg physical or electronic), or due to the nature of the business structure adopted. A lack of neutrality may also be demonstrated where income is taxed differently depending upon its characterisation or its source. Also, although distortions due to tax avoidance are discussed under the “prevention of tax avoidance” criterion, distortions arising from tax avoidance will also be briefly noted in evaluating neutrality.

C. Simplicity

The simplicity of, or conversely, the complexity of, the legal rules relating to residency and source will be qualitatively illustrated through identifying when the law does not in certain circumstances give rise to simple clear outcomes, ie the circumstances illustrate that the law does not meet the seven concepts underlying the simplicity.²⁶³ Thus, if the law in application is:

- not predictable – there is difficulty in understanding a rule’s intended (and actual) scope;
- not proportional – its complexity is disproportional to the complexity of the policy;
- not consistent – involves arbitrary distinctions;
- associated with the imposition of high compliance burdens;

- difficult to administer;
- not co-ordinated with other tax rules; or
- expressed unclearly,

then it will be considered to have failed the simplicity objective in that circumstance, for that stakeholder. When focusing on reform, recommendations will be similarly examined using the policy objective to illustrate where a recommendation does give rise to greater simplicity.

D. Prevention of tax avoidance and evasion

The extent to which the legal rules relating to residency and source meet the tax policy objective of preventing tax avoidance and evasion will be qualitatively illustrated through identifying where there appears to be evasion or avoidance opportunities. Similarly, in the reform context, the focus will be upon reviewing alternative rules that limit the scope for evasion or avoidance opportunities.

E. Conflicts between the objectives

Given the legal focus of the thesis the approach will be that where examples that one or more of the four tax policy objectives are not met or are in conflict, in seeking to evaluate the adequacy of the law and reform options in terms of the tax policy objectives, the focus will be on equity. However, as emphasised earlier, where the equity objective leads to negative outcome in terms of simplicity (complexity) and tax avoidance, the reform option that will prevail is that which provides a balance between the equity tax policy objective and the simplicity and anti-avoidance tax policy objectives.

F. Summary

In summary, given the legal focus of the thesis, the approach will be to use examples in practical operation of the law to qualitatively illustrate situations where equity, efficiency and simplicity and the specific objective of prevention of tax avoidance are not met and to evaluate the effectiveness of reform options through similar means.

Chapter 3

Residency of Individuals

1. Purpose of this Chapter

As nation states consist of people, it is the individual who is impacted upon by the rules relating to residency and source. As mentioned in Chapter 1 the first focus of this chapter is to evaluate Australia's residency rules as they apply to individuals in light of the main thesis, ie, do the residency rules for individual taxpayers, contained in the 1997 Act, satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance. Integral to this analysis is the need to first explore the operation of the rules (in Part II) in order to provide the necessary basis to enable evaluation of each category of the residency tests against the evaluative criteria (in Part III).

The latter part of the Chapter explores the sub-thesis (ie alternative approaches to the current rules that may better satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance).

In Part IV comparative studies of the domestic approaches adopted in other jurisdictions are undertaken. A contextual review of the rules in selected jurisdictions is undertaken before evaluating the residency rules adopted more broadly. This contextual comparison highlights the hierarchy of residency tests in each jurisdiction, which cannot be demonstrated in the context of the evaluation of individual rules.

In light of the comparative analysis, a number of reform options (that are within Australia's jurisdictional claims) are evaluated (in Part V) against the evaluative criteria in order to determine whether the proposed rules are more equitable, efficient, simple and able to prevent tax avoidance.

Finally, in Part VI the findings and recommendations made within the chapter are summarised.

II. Exploring the Main Thesis – Scope of the residency rules for individuals

As mentioned above, the preliminary step in evaluating the main thesis is the need to explore the scope of the residency rules applicable to individuals. This first involves exploring the principal residency tests contained in s 6(1) of the 1936 Act before exploring the other residency definitions and rules that impact or alter the scope of the those principal residency tests in specific circumstances. Finally, as the domestic residency definitions can be overridden by the residency tie-breaker test contained in most Australian bilateral tax treaties (so-called “Double Tax Treaty” or “DTA”), for completeness it is important to explore the impact of DTAs on the scope of the domestic residency rules.

A. Defining the scope of the principal residency test for individuals

The exploration of the scope of the principal residency rules applicable to individuals contained in s 6(1) of the 1936 Act will be undertaken by first providing an overview of the rules and their interrelationship before exploring the scope of each of the rules in detail.

1 Overview of the principal residency rules

For the purposes of this research the term “Australian resident” is central and is defined in s 995-1 of the 1997 Act as a person who is a resident under the 1936 Act. The principal residency test in the 1936 Act is contained in s 6(1), which defines a “resident” or “resident of Australia” as follows:

“resident” or “resident of Australia” means-

(a) a person, other than a company, who resides in Australia and includes a person-

- (i) whose domicile is in Australia, unless the Commissioner is satisfied that his permanent place of abode is outside Australia;
- (ii) who has actually been in Australia, continuously or intermittently, during more than half of the year of income, unless the Commissioner is satisfied that his usual place of abode is outside Australia and that he does not intend to take up residence in Australia; or

(iii) who is :

- (A) a member of the superannuation scheme established by deed under the Superannuation Act 1990; or
- (B) an eligible employee for the purposes of the Superannuation Act 1976; or
- (C) the spouse, or a child under 16 years of age, of such a person covered by sub-subparagraph (A) or (B);¹

The definition contains four distinct residency tests. The first is the primary or common law test, which classifies an individual as a resident if he or she can be said to be actually “residing in Australia”.² The three other tests (the domicile test, the 183 day test and the Commonwealth superannuation test) extend residency to individuals who may not reside in Australia in terms of the primary test.

The Explanatory Notes to the amending Act³ introducing the residency rules appear to indicate that the common law test has primacy in application, by stating that:

[i]f a person is in fact residing in Australia then, irrespective of his nationality, citizenship or domicile, he is to be treated as a resident for the purposes of the Act.⁴

However, that hierarchy is not generally borne out in practice where the courts tend to apply the relevant extension tests (ie either the domicile test, or the 183 day test or the Commonwealth superannuation test) in conjunction with the common law resides test.

A person who is not a resident under these tests is not an Australian resident for tax purposes. Although the concept of a “non-resident” in s 6(1) of the 1936 Act did not initially carry across to 1997 Act, it remains operative for the 1936 Act.⁵

1 The s 6(1) definition in the 1936 Act is identical to the original definition enacted by the *Income Tax Assessment Act 1930* (Cth), except for the superannuation test (s 6(a)(iii)), which was added by the *Income Tax Assessment Act 1939* (Cth). The subsequent changes to the s 6(i) definition only reflect changes to the Commonwealth's superannuation scheme named in s 6(a)(iii).

In fact the definition of “Australian resident” in s 995-1 of the 1997 Act is used for the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (the GST Act), s 195-1.

2 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 9.

3 The “residents” definition was introduced via s 2(i) of the *Income Tax Assessment Act 1930* (Cth).

4 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 9.

5 The 1936 Act still has provisions that expressly treat “resident” persons as non-residents in limited circumstances. For example s 23AA(3) treats certain members of the US forces and dependents living in Australia as non-residents. For details of the replacement terminology in 1997 Act see Chapter 1, n 19.

The scope of the s 6(1) residency tests will be explored by first examining the common law test before examining the three extension tests (the domicile test, the 183 day test and the Commonwealth superannuation test).

2 *The primary or common law test*

The primary test is whether a person can said to be “residing in Australia”. The purpose of the test was to extend the scope of the Act to income derived outside Australia where it is derived by persons who ordinarily live in Australia and those persons who have retained foreign nationality, citizenship or domicile but whose usual place of residence is Australia.⁶

(a) *Overview*

In an early case Dixon J in *Gregory v Deputy Commissioner of Taxation (WA)* stated that the word “resident” in s 5A of the 1922 Act:

. . . should receive the same meaning and application as “person residing” and “ordinary resident” have been given in England.⁷

Thus, in interpreting the meaning of the term “resides” the Australian courts initially relied on English precedents such as *Levene v Inland Revenue Commissioners*⁸ (*Levene*) and *Inland Revenue Commissioners v Lysaght*⁹ (*Lysaght*). Early authors also looked to English precedents in interpreting this aspect of the law.¹⁰ In more recent times, the principles arising from early Australian decisions have assumed pre-eminence. However, as these Australian decisions were decided in light of, and in reliance on, these early English decisions, the English decisions still have strong precedent value.¹¹

6 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 10. However, why the “resides” test was adopted in preference to say a citizenship test is uncertain. Its roots probably lie in reliance on English and New Zealand models - see Peter Harris, *Metamorphosis of the Australasian Income Tax: 1866 to 1922* Research Study No 37, Australian Tax Research Foundation (2002) 207.

7 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774, 777; 4 ATD 397, 399; 1 AITR 201, 202.

8 *Levene v Inland Revenue Commissioners* (1928) 13 TC 486.

9 *Inland Revenue Commissioners v Lysaght* (1928) 13 TC 511.

10 See especially J P Hannan, *A Treatise on the Principles of Income Tax* (1946) 250-279; A J Baldwin and J A L Gunn, *The Income Tax Laws of Australia* (1937); and J V Ratcliffe, J Y McGrath and J W R Hughes, *The Law of Income Tax (Commonwealth)* (1938).

11 Gzell notes that Australian “. . . courts have tended to follow decisions of the UK courts notwithstanding the contrast” in legislation – see Ian Gzell, ‘Residency and Permanent

The courts have given the word “reside” a very wide meaning. Justice Northrop in *Applegate v Federal Commissioner of Taxation*¹² adopted the dictionary meanings of the word, describing “reside” to mean “. . . to dwell permanently or for a considerable time, to have one's settled or usual abode, to live, in or at a particular place”.¹³ Justice Williams in the *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation*¹⁴ stated (obiter) that:

[t]he place of residence of an individual is determined, not by the situation of some business or property which he is carrying on or owns, but by reference to where he eats and sleeps and has his settled or usual abode. If he maintains a home or homes he resides in the locality or localities where it or they are situate, but he may also reside where he habitually lives even if this is in hotels or on a yacht or some other place of abode . . .

Accordingly, whether an individual is a resident will depend upon their individual circumstances (ie it is determined on a case by case approach).¹⁵

(b) Factors that assist in determining where a person resides

In looking at a person's individual circumstances there are a number of factors (but no simple test) that assist in determining where a person resides. These factors include:

- physical presence;
- term of any employment or appointment;
- nature of the person's family, business and social tie;
- frequency and regularity of a person's movements; and
- intention (purpose) of visit or trip.

Establishments’ (1997) *Taxation Institute of Australia 1997-98 Convention Papers* 20, 21. However, Ian Gzell, ‘Concepts of Residence and Source into the 21st Century’ (Paper presented at the Taxation Institute of Australia’s Victorian Division’s *International Tax into the 21st Century Red Series Intensive Retreat*, 14-15 June 1996), 5 argues that given that many English and Scottish decisions have been decided on the subtlety of the differentiation between the terms “resident” and “ordinary resident”, Australian courts in applying the residency definition should not place any store on the United Kingdom decisions that turn on the meaning of the words. Also see Justices Kerwin (at 818) and Taschereau (at 823) expressed similar reservations about the application of these cases in Canada in *Thomson v Minister of National Revenue* [1946] DTC 812.

12 (1979) 9 ATR 899, 905; 79 ATC 4307, 4313.

13 Viscount Cave LC used this same definition earlier in *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, 505. Similar concepts are found in obiter dicta of Huddleston B in *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88, 103 who stated “[y]ou do not find any very great difficulty in defining what is the residence of an individual; it is where he sleeps and lives.”

14 (1941) 2 AITR 167, 172; 64 CLR 241, 249; 6 ATD 82, 87.

15 *Federal Commissioner of Taxation v Miller* (1946) 3 AITR 333; 73 CLR 93; 8 ATD 146.

However, it must be remembered that although these factors, which are set out in the following, provide broad guidance, each determination of residency turns on its own particular facts.

(i) Physical presence

First, a physical presence in the country is a factor that determines where a person resides.¹⁶ In *Federal Commissioner of Taxation v Efstathakis*¹⁷ a physical presence in Australia for eleven years was an important factor in determining residence, while the actual number of days spent in Darwin was important in *Gregory v Deputy Commissioner of Taxation (WA)*.¹⁸ Similarly, physical presence was important in determining residence for a mythical tramp wandering the country and residency for a wealthy person wandering from hotel to hotel.¹⁹

The duration of physical presence can also indicate residency, however, mere presence is not always sufficient to establish residence.²⁰ For example, foreign nationals on working holidays, who travel around the country living in temporary accommodation, would not usually be regarded as residing in Australia under the ordinary concepts test due to the transitory nature of their presence.²¹ In supporting this view the Commissioner, in Taxation Ruling TR 98/17, makes the pragmatic observation that “[i]n most cases, the

16 Ibid and Taxation Ruling TR 98/17, *Income Tax: Residency Status of Individual Entering Australia*, paras 18, 22-28, 68-89. TR 98/17 replaced Taxation Ruling IT 2607, *Income Tax: Residency Status of Visitors and Migrants* that was withdrawn from 25 November 1998. IT 2607 was withdrawn as it “... did not provide sufficient guidance about the ordinary meaning of residing here when the stay in Australia was between six months and two years” (TR 98/17 at para 7). The Commissioner's views on lack of presence in determining the residency status of business migrants is set out in Taxation Ruling IT 2681, *Income Tax: Residency Status of Business Migrants*.

17 *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82, 86; 78 ATC 4486, 4490.

18 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774; 4 ATD 397; 1 AITR 201.

19 *Reid v Inland Revenue Commissioner* (1926) 10 TC 673, 679 (Lord Clyde). Similarly in *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, a taxpayer who stayed in hotels in England or abroad for over seven years was found to be a resident despite having no fixed abode.

20 The former IT 2607 (above n 16) provided a very pragmatic approach to determining when physical presence would indicate residency. The former IT 2607 stated at para 12:

“... as a general rule, a person whose intended visit to Australia was less than 6 months would not be regarded as “residing” in Australia during that visit... However, a person whose intended visit to Australia was greater than 2 years would generally be regarded as residing in Australia during that person's stay.”

This two year “rule”, although administrative, was commonly viewed as defining the period for retention of residency - see Pierre Fontaneau *et al*, ‘The idea of resident’ (1977) 12 *Taxation in Australia* 279, 283 and Arthur Andersen, *Working Overseas* (c 1988), 2.

21 TR 98/17, above n 16, para 55 and former IT 2607, above n 16, para 9.

Commissioner accepts that a visit to Australia of less than six months is not sufficient time to be regarded as residing here.”²²

Similarly long periods of presence may not indicate residency. This is illustrated at first instance in *Re Executors of the Estate of Subrahmanyam v Federal Commissioner of Taxation*²³ where a taxpayer who lived in Australia from September 1994 until her death in June 1998 was found not to “reside” in Australia as she had never intended to make her home Australia.

Conversely, absence from Australia will not prevent residency being found.²⁴ For example, “a migrant who settles with his family in Australia would usually be regarded as residing in Australia from the date of his arrival, notwithstanding that his business or personal interests might require him to be absent from Australia for extended periods”.²⁵

AAT Case 13559: Re Crockett and Federal Commissioner of Taxation is illustrative. In that case a taxpayer who was employed as a permanent baggage handler in the United Kingdom and only spent 57 and 60 days in Australia in the 1988 and 1989 income years was still found to be resident in Australia as his family ties, locality of assets and home

22 TR 98/17, above n 16, para 62.

23 (2001) 47 ATR 1127; 2001 ATC 2177. The Full Federal Court, on appeal, overturned the AAT's decision on the grounds of misapplication of the 183 day test (*Federal Commissioner of Taxation v Executors of the Estate of Santh Thevy Subrahmanyam* (2002) 49 ATR 29; 2002 ATC 4001), but the finding that the taxpayer was not “resident” in Australia finding was not overturned. However, the AAT (SA Forgie) found on review that in absence of an usual place of abode outside Australia the deceased must be considered a resident in Australia under the 183 day test (Case [2002] AATA 1298 re *Executors of the Estate of Santh Thevy Subrahmanyam v Federal Commissioner of Taxation* (2002) 51 ATR 1173; 2002 ATC 2303).

24 This is illustrated by the Scottish mariner's cases where the seamen were found to be “ordinary resident” despite being at sea for the greater part of the year (*In Re Young* (1875) 1 TC 57) or the entire year (*Rogers v Inland Revenue Commissioners* (1879) 1 TC 225) and only returning home between voyages. Also see Case [2002] AATA 610 re *Joachim and Federal Commissioner of Taxation* (2002) 50 ATR 1072; 2002 ATC 2089) where the taxpayer, who was a permanent resident of Australia, spent 316 days during the year of income as a first Officer on a Sri Lankan flagged ship. Senior Member MD Allen found that as he maintains a home for his wife and children in Australia he is a resident of Australia. These consistent decisions are explained by the statement of Rowlatt J in *Pickles v Fulsham* (1923) 9 TC 261 at 275 that “a sailor resides at the port where his wife and children live”.

Also in *Slater v Commissioner of Taxes* [1949] NZLR 678; 4 AITR 249; 9 ATD 1 a medical practitioner, held as a prisoner of war between 1940 and 1944, was found to be “ordinarily resident” in New Zealand as his home was always in New Zealand, his family had been maintained there during his absence and he had not been resident elsewhere. Northcroft J stated that he was no more than a sojourner and although he had continued presence in prisoner of war camps, he could not said to be resident in the camps (683-4, 253 and 4 respectively).

25 See *Macrae v Macrae* [1949] 2 All ER 34, *Stransky v Stransky* [1954] 2 All ER 536, and TR 98/17, above n 16, paras 52-60.

were Australia.²⁶ AAT Senior Member KL Beddoe decided that the taxpayer was a resident on the ordinary concepts test, finding that the factors of intention existed as:

. . . evidenced by the deliberate decision in 1987 to migrate to Australia, the subsequent application and grant of citizenship and the family and social ties with Australia evidenced by the fact that the applicant and his family lived in Australia until 1996.²⁷

But where that absence is so great as to sever attachment, Australian residency ceases. An example is *AAT Case 4833*²⁸ where an Australian born taxpayer who had left Australia for almost nine years, residing in Greece and the United States, was found to no longer be resident in Australia.

(ii) Term of any employment or appointment

Secondly, the term of any employment or appointment is another factor that may influence in the determination of residency. In *Federal Commissioner of Taxation v Pechey*²⁹ the taxpayer's appointment to the Cocos (Keeling) Islands for four weeks was held to be insufficient time to establish residence.

(iii) Nature of the person's family, business and social ties

Thirdly, the nature of the person's family, business and social ties (ie whether accompanied by family, location of assets in Australia, place where children are educated) can also determine residency.³⁰ In *Federal Commissioner of Taxation v Efstathakis*³¹ Mears J noted that:

26 (1998) 41 ATR 1156; reported in ATCs as *Crockett (No 2) v Federal Commissioner of Taxation* 99 ATC 2221.

27 Ibid, 1160 and 2224 respectively. This result is consistent with the early English Court of Exchequer case of *Attorney-General v Coote* (1817) 4 Price 183; abstract published in (1887) 2 TC 385, where Sir C H Coote, who was born, was domiciled and resided in Ireland for the greater part of the year, was found to be resident in Great Britain as he had lived for a few weeks, from time to time in a house he owned in London. Also see *Case [2003] AATA 279: Re Shand and Federal Commissioner of Taxation* (2003) 52 ATR 1088, 2003 ATC 2080.

28 (1988) 20 ATR 3117; *Case W14* 89 ATC 201. The Administrative Appeals Tribunal (AAT) concluded “. . . we cannot be satisfied that the applicant has resided in Australia in the sense that he has dwelt permanently or for a considerable period of time in Australia as at the relevant year ” (at 3120 and 204 respectively).

29 (1975) 5 ATR 322; 75 ATC 4083.

30 See eg *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82; 78 ATC 4486, *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, and TR 98/17, above n 16, paras 57-51.

31 *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82, 86; 78 ATC 4486, 4490.

[a]ny submission that the respondent was resident in Australia during the relevant time only because of the exigencies of her service is, in my opinion, beside the point. The respondent . . . has continuously resided in Australia since August 1968 until this date. In July 1969, she married a Greek citizen who had resided in Australia continuously since 1965 and who at the end of 1970, became a permanent citizen of Australia. She and her husband, since the date of their marriage, have set up a marital establishment and had their home in Sydney ever since that date. In light of these facts the respondent was, in my opinion, at the relevant time ordinarily resident in Australia.

In *Gregory*³² the fact that Darwin was the taxpayer's “. . . chief and principal place of business activity and social life” was also a factor in determining his residency.

(iv) Frequency and regularity of a person's movements

Fourthly, the frequency and regularity of a person's movements is another important factor in determining residency.³³ In *Lysaght*³⁴ it was the crucial factor in the House of Lords finding that the taxpayer, who had retired to Ireland but attended monthly directors' meetings, was a resident. The House of Lords found the taxpayer to be a resident despite the fact that the taxpayer's only place of abode was Ireland.

(v) Intention (purpose) of visit or trip

Finally, the purpose (ie intention) of a visit to Australia, and of a trip abroad is another factor that influences a residency determination.³⁵ In *Levene* the taxpayer's purpose for travelling abroad was for his health and that of his wife. The House of Lords relied upon this stated purpose in determining that his place of residency was England (as “. . . none of these purposes was more than a temporary purpose”³⁶). However, as it is clear from *Lysaght*³⁷ residency can be established even where a person is compelled to reside

32 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774, 778; 4 ATD 397, 399; 1 AITR 201, 202. See also *Lloyd v Sulley (Surveyor of Taxes)* (1884) 2 TC 37, 45 (Lord Shand).

33 *Loewenstein v De Salis* (1925) 10 TC 424. See also *Cooper v Cadwalader* (1904) 5 TC 101 where an American resident in New York who leased a hunting lodge in Scotland was a resident there despite only living in Scotland for two months.

34 *Inland Revenue Commissioners v Lysaght* (1928) 13 TC 511.

35 See generally former IT 2607, above n 16, paras 9-11. Richards CB noted in the early English Court of Exchequer case of *Attorney-General v Coote* (1817) 4 Price 183; abstract published in (1887) 2 TC 385, that “. . . if the defendant came here for the purposes of establishing a residence, it were enough.”

36 *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, 506 (Viscount Cave LC).

37 *Inland Revenue Commissioners v Lysaght* (1928) 13 TC 511, 535 (Lord Buckmaster).

against his or her will.³⁸ Absence of any intention to reside will also not prevent a finding of residency.³⁹ Thus, purpose will generally be a factor of limited importance, as is a person's nationality⁴⁰ or visa status.⁴¹

(vi) *Summary*

In summary, all the five factors discussed above must be taken into account when determining residency. It is only after weighing up the some time competing factors that arise in a particular factual circumstance can residency in that case be determined under the common law. Given the additional work associated with facts and circumstances analysis, as mentioned above, the courts tend to apply the relevant extension definition (ie either the domicile test, or the 183 day test or the Commonwealth superannuation test) in conjunction with the common law resides test.⁴²

38 In *Canberra Income Tax Circular Memorandum (CITCM) No 63*, issued by the Commissioner of Taxation on 28 July 1932, an English domiciled wife of a State Governor who was appointed from the United Kingdom was considered to be a resident as she resided in Australia during the term of the Governor's appointment, despite having a residence in the United Kingdom. Contrast this with *CITCM No 490* issued on 6 June 1945 that ruled that the son and daughter of the United States Consul were considered as visiting Australia as their father could only be regarded as being temporarily in Australia.

39 This is illustrated in *AAT Case 11255* (1996) 33 ATR 1264; *Case 59/96* 96 ATC 553 where the AAT found that the taxpayer on a student visa who attended secondary school in Australia and then spent four years at university in Australia clearly satisfied the definition of resident. Senior Member BH Pascoe noted (at 1268 and 556 respectively) that even if it was accepted "... that the applicant could not form an intention to take up residence in Australia, this is only relevant to a person whose usual place of abode is outside Australia." Similarly, in *Re Mackenzie* [1941] Ch 69 an Australian domiciled woman was found to be ordinary resident in the United Kingdom after being committed to a sanatorium (ultimately for 54 years) four months after her arrival in the United Kingdom in 1885. Also see *Miesegeaes v Commissioners of Inland Revenue* (1957) 37 TC 493 where a taxpayer, a child war refugee who subsequently attended boarding school in England to complete his education, was found to be ordinary resident in England despite being a minor.

40 Roger Hamilton, Robert Deutsch and John Raneri, *Australian International Taxation* (October 2002), para 2.100 note that there will be very few cases where nationality will be a decisive factor and in only marginal cases will it be relevant. See also Anthony Sumpton, 'Residence' (1974) 3 *Australian Tax Review* 13, 15 and 25.

41 *AAT Case 11255* (1996) 33 ATR 1264; *Case 59/96* 96 ATC 553. Senior Member BH Pascoe noted (at 1267/556) that "[t]he definition of residence in s 6 of the Act requires the Commissioner to be satisfied that the taxpayer "does not intend to take up residence in Australia". The words do not refer to "permanent residence", simply "residence". Similarly, the AAT found that little weight could be given to a letter seeking permanent residence for the taxpayer's mother. Also see *Federal Commissioner of Taxation v Executors of the Estate of Santh Thevy Subrahmanyam* (2002) 49 ATR 29; 2002 ATC 4001 where no weight was given to the grant of a temporary retirement visa. However, consistent statements of non-residency on a person's immigration departure cards were found by Lindgren J in *Federal Commissioner of Taxation v Wong* (2002) 50 ATR 203, 206; 2002 ATC 4538, 4540 to be persuasive in finding non-residency.

42 Clinton Alley and Duncan Bentley, 'In Need of Reform? A Trans-Tasman Perspective on the Definition of 'Residence'' (1995) 5 *Revenue Law Journal* 40, 48 suggested that it is often simpler to start with the specific deeming provisions rather than relying on the common law.

3 Extension Tests

As mentioned above, there are three other tests (the domicile test, the 183 day test and the Commonwealth superannuation test) that extend the definition of resident to individuals who may not reside in Australia in terms of the primary test. In order to fully explore the scope of the residency tests, the broad scope of each test will be examined in turn.

(a) *The domicile test*

The first extension test is the so called “domicile test” in s 6(1)(a)(i) of the 1936 Act. Under s 6(1)(a)(i) persons whose domicile is Australia are treated as residents regardless of any physical presence in Australia.⁴³ It merely was intended to place public officials located abroad in the same position as foreign public officials representing their governments in Australia.⁴⁴

(i) *What is domicile?*

Domicile is a general common law concept, received from the United Kingdom upon settlement, which has been modified in Australia by the *Domicile Act 1982* (Cth) (Domicile Act).⁴⁵ Domicile is a legal relationship between a person and a country by which the person is able to invoke the country's laws as their own.⁴⁶ In other words, a person's domicile is his or her “permanent” home rather than where he or she resides. In order to establish domicile, the person must have residence in a country, and have the

43 Where a migrant taxpayer living in Australia has left their dependants in the country of origin while establishing a base in Australia s 159J(3A) of the 1936 Act deems the dependants to be domiciled in Australia at all times the taxpayer is domiciled in Australia. This deemed residency ensures that the taxpayer is entitled to the dependent rebate (tax offset) in respect of their non-resident dependants (including a spouse and children). Section 159J(3A) was introduced to reverse the effects of the *Domicile Act 1982* (Cth) - see Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 4) 1983 (Cth) 26.

44 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10. The Government had identified that the High Commissioner for Australia in London did not pay tax in Australia as services were rendered outside Australia; they were exempt from British income tax and received the general exemption available to residents on their Australian source income. Baldwin and Gunn, above n 10, 61, in 1937 note that “. . . since 1930 High Commissioners for Australia and Agents-General for the Australian States, together with members of their staffs and other public officials who are located abroad, have been treated as residents of Australia.”

45 The concept of domicile has its origins in the Roman Empire - Denzil Davies, *Booth: Residence, Domicile and UK Taxation* (1995) 167. Domicile has a greater component of pure intention – emotional permanence than residency and is found in expressions such as “Home is where the heart is” and “Once an Englishman, always an Englishman” – see Joseph Isenbergh, *International Taxation* (2003), Vol 1, para P6.3 (electronic).

46 *Henderson v Henderson* [1965] All ER 179.

intention to reside there permanently or indefinitely. There must be a combination of both of these elements for domicile to exist.⁴⁷

Under the common law there are two types of domicile: domicile of origin and domicile of choice. At birth a person acquires a domicile of origin. The actual domicile adopted at birth is the domicile of the person upon whom the infant is legally dependent (ie a domicile of dependency). Therefore, at common law if the person is legitimate, they acquire the domicile of their father, if the person is illegitimate, they acquire the domicile of their mother, and if the person is a foundling, they acquire the domicile of the country in which they were found.⁴⁸

These common law rules are modified by s 9 of the *Domicile Act*, which moves away from using the concept of domicile based on legitimacy to domicile using the place of residence. Thus, where the parents have separated, one has died or the child is adopted the domicile of a child is linked to the parent with which it resides. A domicile of origin remains until there is an adoption of a domicile of choice.⁴⁹ A domicile of choice is acquired in a country where a person voluntarily fixes their sole or chief residence in that country with the intention to continue to reside there indefinitely.⁵⁰ A person may only have one domicile at any time.

The Commissioner in *Taxation Ruling IT 2650 Income Tax: Residency – Permanent Place of Abode Outside Australia* sets out the factors considered to be important in determining a new domicile of choice:

[g]enerally speaking, persons leaving Australia temporarily would be considered to have maintained their Australian domicile unless it is established that they have acquired a different domicile of choice or by operation of law. In order to show that a new domicile of choice in a country outside Australia has been adopted, the person must be able to prove an intention to make his or her home indefinitely in that country eg, through having obtained a migration visa. A working visa, even for a substantial

47 *Case 78* (1944) 11 CTBR. The common law interpretation of “domicile” is very different to the civil law concept of domicile, which is akin to a “place of habitual abode”, similar to the United Kingdom’s “ordinary residence” concept - see Denis Sheridan, ‘Residence in the United Kingdom: Observations on the Inland Revenue Consultative Document’ (1988) 29 *European Taxation* 17, 20.

48 *Udny v Udny* (1896) LR I Sc & Div 441.

49 *Domicile Act 1982* (Cth) s 9(4). Also see *Case [2003] AATA 279: Re Shand and Federal Commissioner of Taxation* (2003) 52 ATR 1088, 2003 ATC 2080.

50 *Domicile Act 1982* (Cth), s 10.

period of time such as 2 years, would not be sufficient evidence of an intention to acquire a new domicile of choice . . .⁵¹

(ii) *The “permanent place of abode” rebuttal*

A finding that a person is domiciled in Australia will not equate with residence under the s 6(1)(a)(i) domicile test, as the person may avoid residency if the person can prove that he or she has established a permanent place of abode elsewhere.⁵² As the “permanent place of abode” rebuttal allows a person to escape the scope of the domicile test, it has been argued that the test is in fact a “permanent place of abode” test rather than a residency test.⁵³

The purpose for the introduction of the rebuttal was to ensure that persons who had abandoned their Australian residence would not continue to be treated as residents. Such a protection was crucial at the time as, in the absence of DTAs, those persons would have been potentially subjected to double taxation in respect of the income earned in their new place of residence.⁵⁴ The double tax problem was further compounded as the common law specified that domicile of origin would revive where domicile of choice is abandoned and the person has not yet acquired a new domicile of choice. The Domicile Act now mitigates this problem by deeming the domicile of choice to continue until another domicile is established.⁵⁵

51 Taxation Ruling IT 2650, *Income Tax: Residency – Permanent Place of Abode Outside Australia*, para 21. See also paras 22 and 23.

52 An illustration is *AAT Case 4833* (1988) 20 ATR 3117; *Case W14* 89 ATC 201. Here an Australian born taxpayer that had left Australia for almost nine years, residing in Greece and the United States, was found to no longer be resident in Australia under s 6(1)(a)(i) domicile test. Although his domicile in Australia was conceded, the taxpayer was found to have permanent place of abode outside Australia. The AAT found that the “. . . applicant’s intention to remain outside Australia for a prolonged and undefined duration, is fatal to his cause” (at 3120 and 204 respectively). Similarly in *AAT Case 4834* (1988) 20 ATR 3121; *Case W13* 89 ATC 196 a naturalised taxpayer who had migrated to Australia in 1962 but then returned to live in Greece from 1977 until 1988 (having visited Australia only twice: one month in 1979 and three months in May 1985) to carry out repairs on buildings was found not to be a resident under either s 6(1)(a)(i) nor ordinary concepts as their place of abode was outside Australia in the 1983 to 1986 income years. “Whilst it is true that the applicants retained assets in Australia including supermarket premises, their house and furniture, and some rental proceeds for the purposes of paying accounts, in every other sense the applicants were living outside Australia during those years and the period was long-term and indefinite” (at 3126 and 200 respectively).

53 This is the converse of New Zealand where the permanent place of abode test is used as a means of establishing residence, not as a means of proving abandonment - see Alley (1995), above n 42, 51.

54 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10. The Explanatory Notes do not explicitly spell out the double tax concern, but major concerns about double taxation existed during this period - see Edwin RA Seligman, *Double Taxation and International Fiscal Cooperation* (1928), 47-50.

As the existence of a permanent place of abode results in taxpayers escaping the domicile test, it is important to determine what constitutes a “permanent place of abode”. Justice Fisher in *Applegate v Federal Commissioner of Taxation* explained the scope of the words, in particular the significance of the word permanent, which he believed:

. . . is used to qualify the expression "place of abode" ie the physical surroundings in which the person lives, and to describe that place. It does not necessarily direct attention to the taxpayer's state of mind in respect of that or any other place . . .

To my mind the proper construction to place upon the phrase "permanent place of abode" is that it is the taxpayer's fixed and habitual place of abode. It is his home, but not his permanent home. It connotes a more enduring relationship with the particular place of abode than that of a person who is ordinarily resident there or who has there his usual place of abode. Material factors for consideration will be the continuity or otherwise of the taxpayer's presence, the duration of his presence and the durability of his association with the particular place.⁵⁶

Although the taxpayer's intention to return is a factor to be considered, the taxpayer's objective intention in respect of the place of abode is crucial in determining whether he or she has established a permanent place of abode, ie the stay must not be intended to be temporary or transitory.⁵⁷ Thus, the fact that a taxpayer's appointment is for a fixed term is not crucial in determining if the taxpayer has a “permanent place of abode” elsewhere, nor is a subsequent change in intention.⁵⁸

55 *Domicile Act 1982* (Cth) s 7.

56 (1979) 9 ATR 899, 910-11; 79 ATC 4307, 4317. Applegate, a solicitor, was asked by his firm to go to the New Hebrides (now Vanuatu) to establish a branch office and manage it. Applegate gave up the lease on his flat and moved with his family. Although his stay was for an unspecified time, he was forced by illness to return within two years. He claimed his foreign source income was exempt because he was a non-resident for tax purposes. Although the Full Federal Court held that he had retained his Australian domicile, they found that he had established a permanent place of abode elsewhere.

57 Ibid. In *AAT Case 12551* (1998) 37 ATR 1263; *Case 2/98 98 ATC 105* the AAT found that a physiotherapist who had been overseas from mid 1992 to mid 1997 was still a resident as she had not abandoned her domicile nor established a “permanent place of abode” elsewhere. She had “. . . maintained her touring activities satisfying me that she had never lost the essential character of a tourist. She was . . . a typical Australian tourist seeing the world and obtaining work experience.” (at 1267 and 108 respectively). In contrast in *Case [2002] AATA 670 re Wessling v Federal Commissioner of Taxation* (2002) 50 ATR 1187; 2002 ATC 2097 the AAT (BJ McCabe) found that the taxpayer, who took special leave from her job to accompany husband on his three year contract of employment in Fiji, had made her home overseas with her three children, albeit for a limited time.

58 See, eg, *Federal Commissioner of Taxation v Jenkins* (1982) 12 ATR 745; 82 ATC 4098 where a bank officer, appointed to the New Hebrides for three years, who returned home unexpectedly after 18 months, was found to have established a “permanent place of abode” in the New Hebrides. See also *Case R92 84 ATC 615*; *Case 145 27 CTBR (NS) 1131* where an engineer returned earlier than expected to Australia after a project in the Philippines, predicted to last a minimum of three to four

(b) *The 183 day test*

As mentioned above the second extension test is the so-called “183 day test”. Under the 183 day test in s 6(1)(a)(ii), persons who are present, continuously or intermittently in Australia for a total of more than 183 days are deemed to be residents. The test was introduced for the purpose of obviating the difficulties in establishing if a person is a resident in any country.⁵⁹ An argument that the test has a role in determining continuation of residency has been rejected.⁶⁰

The measurement for residency under the 183 day test in s 6(1)(a)(ii) is an income year (ie 1 July to 30 June). Thus, a taxpayer could spend up to 364 days in Australia without satisfying the 183 day test provided the 182 days were prior to 1 July and the balance were from 1 July. As a day is not defined (even by the *Acts Interpretation Act 1901* (Cth)) it is not clear what time period constitutes a day (ie whether part of a day constitutes a day). However, it appears that the 183 days need not be consecutive and the period includes days of arrival and departure and days of involuntary stay (due to sickness or industrial action).⁶¹

However, mere presence for 183 days is not sufficient by itself to establish residency. Persons may escape this deeming provision if they establish both that they have a usual place of abode outside Australia and do not intend to take up residency. This exception was enacted (in the absence of DTAs in 1930) to reduce the possibility of the double taxation by ensuring that the visitors were not treated as residents.⁶² A taxpayer’s

years, was completed in little over two years. See also the Commissioner’s view on the decision in Taxation Ruling IT 2221, *Income Tax: Income Derived by Non-Resident from ex-Australian Source, Permanent Place of Abode*.

59 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 11.

60 The Commissioner in *Case 29* (1985) 28 CTBR (NS) *Case S19 85* ATC 225 argued that a taxpayer who had been continuously present for more than 183 days was deemed under s 6(1)(a)(ii) to continue to be a resident for the whole of the year despite departing Australia for the New Hebrides in 14 April 1978. The Taxation Board of Review rejected this argument finding the taxpayer was not resident for the period 14 April to 30 June. The Board found the purpose of the 183 day test is to aid in determining residency and it plays no part in determining when someone departs Australia - see especially Roach P at 248 and 232 respectively.

61 In other countries the days of arrival and departure are excluded from the 183 day calculation. Although focused on the interpretation of the words in art 15 of the OECD Model Convention, the OECD Committee on Fiscal Affairs’s report, *The 183 Day Rule: Some Problems of Application and Interpretation* (1991), illustrates the different calculation approaches taken in the past.

62 That is, to ensure there was “. . . no danger of treating as residents persons who are purely visitors” - see Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 11. Also see Seligman (1928) above n 54.

individual facts and circumstances will determine if a usual place of abode exists elsewhere and whether there was no intention to take up residency.

The exclusionary condition is not satisfied simply by the fact that the person does not have a usual place of abode in Australia; they must establish that they have a usual place of abode elsewhere.⁶³ The use of the word “usual”, rather than “permanent”, to qualify the words “place of abode” does seem to imply that the exclusionary test is less stringent than that under the domicile test.⁶⁴ Thus, “usual” in this context connotes that the “place of abode” be that “. . . in ordinary use, current, prevalent, habitual, customary”.⁶⁵

Thus, overseas visitors on holidays or working in Australia (eg visiting academics) who are in Australia for more than 183 days would not be residents during their stay under this test, as they would usually have a usual place of abode elsewhere and would not have an intention of taking up residence in Australia.⁶⁶

(c) The Commonwealth superannuation test

The third extension test is the so-called superannuation test. Under the superannuation test in s 6(1)(a)(iii), a person who is either a member of the superannuation scheme established by deed under the Superannuation Act 1990 (Cth) or an eligible employee or for the purposes of the Superannuation Act 1976 (Cth) (the “named schemes”) is deemed to be a resident. These superannuation schemes are the Commonwealth Superannuation Scheme (CSS) and the Public Service Scheme (PSS).

The purpose for introducing the superannuation test was to bring within the Australian taxable field the salaries paid to locally engaged High Commission staff, who had recently been extended the benefits of the Commonwealth superannuation scheme.⁶⁷

63 *Federal Commissioner of Taxation v Executors of the Estate of Santh Thevy Subrahmanyam* (2002) 49 ATR 29; 2002 ATC 4001. See also Justice D Graham Hill, ‘Contemporary Tax Practice’ (Paper presented at the 14th Australasian Tax Teachers Association Conference, Auckland, 18 January 2002) 13-14.

64 Hamilton, above n 40, para 2.120.

65 *Case G 54* (1956) 7 TBRD 311, 313 (FC Bock).

66 Former IT 2607, above n 16, para 16.

67 Commonwealth, *Parliamentary Debates*, House of Representatives, 21 September 1939, 964 (Sir Percy Spender, Assistant Treasurer).

However, currently locally engaged staff are now expressly excluded from joining both the PSS and CSS schemes.⁶⁸

The spouse, or a child under 16 years of age, of such a person is also deemed by that relationship to be a resident under the test, regardless of the degree of actual connection between the spouse and/or child and Australia. Further, in respect of the *Superannuation Act 1976 (Cth)* the person does not need to contribute to the superannuation fund, all they have to be is an “eligible employee”⁶⁹ or a member of the 1990 Superannuation fund.⁷⁰ This test has a strict application.⁷¹

It is also important to note that the scope and relevance of the superannuation test long term may be potentially reduced following the enactment on 30 June 2004 of the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004 (Cth)*.⁷² The Act generally will enable employees, from 1 July 2005, to choose the complying superannuation fund to which their employers are required to make compulsory superannuation contributions. Although contributions made on behalf of public servants to the current Commonwealth superannuation schemes (CSS and PSS) are deemed to satisfy the choice of fund requirements, there is scope in the future to

68 See s 3(1) of the *Superannuation Act 1976 (Cth)* (and the *Public Service Act 1922 (Cth)*, s 7(1) and Division 10 of Part III) and *Superannuation Act 1990 (Cth)*, s 3.

69 An “eligible employee” is defined in s 3(1) of the *Superannuation Act 1976 (Cth)* to be a “permanent employee”, which in turn is defined in s 3(1) to be an “officer” for the purposes of the *Public Service Act 1922 (Cth)*. Section 7(1) of the *Public Service Act 1922 (Cth)* defines an “officer” to be a person appointed or transferred to the service but does not include an “employee”, which is in turn defined in s 7(1) to be persons employed under Division 10 of Part III of the *Public Service Act 1922 (Cth)* (ie continuing, short-term, fixed-term or overseas employees).

70 A member is defined to include permanent employees, holders of statutory office, the Commissioner and temporary employees (*Superannuation Act 1990 (Cth)* s 6(1)). All these terms are defined in s 3, with the terms “permanent employee” and “temporary employee” adopting the meanings assigned by the *Public Service Act 1922 (Cth)*. However, expressly excluded from the definition of “temporary employee” in s 3 are persons engaged or appointed for employment outside Australia. Also excluded under s 6(2)(a) are persons who are not an “eligible employee” for the purposes of the *Superannuation Act 1976 (Cth)*.

71 An illustration of the strict application of the superannuation test is *AAT Case 8892 (1993) 27 ATR 1136*; *Case 11/94 94 ATC 175* which concerned an Australian customs officer, on leave without pay from the Australian Customs Service who was employed in the Solomon Islands for three years. As he continued to contribute to his Commonwealth superannuation scheme, he was an eligible employee for the purposes of the *Superannuation Act 1976 (Cth)* and deemed to still be a resident of Australia under s 6(1)(a)(iii).

72 This Act was introduced on 26 June 2002 as *Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002*. The 2002 Bill was a replacement for the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 1998*, which was introduced on 12 November 1998, but had stalled in the Senate before subsequently lapsing with the dissolution of Parliament on 5 October 2001.

allow public servants a choice of funds. If this occurs, the number of persons to whom the superannuation residency test applies will fall conversely.⁷³

(d) Summary

Thus, the definition of residency for an individual in s 6(1) of the 1936 Act (via s 995-1 of the 1997 Act) consists of the resides test and three extension tests. As discussed above, although the common law test was intended to have primacy in application, that hierarchy is not generally borne out in practice where the courts tend to apply the relevant extension definition (ie either the domicile test, or the 183 day test or the Commonwealth superannuation test) in conjunction with the common law resides test. As a result of the principally case-by-case nature of all of these rules, a large body of common law has been adopted through the use of common terminology and further developed through litigation. The consequence of this will be dealt with later in the context of the evaluation of the four tests.

B. Defining the scope of the specific purpose residency test for individuals

Contained within the tax laws and related legislation there exists a number of specific residency definitions and other rules that impact upon the scope of the s 6(1) rules discussed above. The scope of these rules is examined by looking at the impact of:

- the continuous foreign service exemption;
- alternative income tax law definitions; and
- the other definitions contained in related tax legislation.

1 Continuous foreign service exemption

Section 23AG of 1936 Act provides an exemption with progression for income arising from continuous foreign service. Exemption with progression means that although the foreign service income is exempt, that income is still taken into account in determining

⁷³ *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004 (Cth)*, ss 32C(1), (3) (4) and 32NA(2)(a). Indicative of change is the Government's announcement that the PSS would can from a defined benefit scheme to a fully funded accumulation scheme from 1 July 2005 - Minister for Finance and Administration, 'New Superannuation Arrangements for Australian Government Employees' (Press Release No 29, 17 October 2003).

the rate of tax applicable to other taxable income earned by the resident. The section was introduced as part of the foreign tax credit system for the purpose of ensuring the administrative integrity of the foreign tax credit system, by removing many small taxpayers from its operation.⁷⁴

Section 23AG, which only applies to residents, provides that where a taxpayer receives foreign employment income in respect of a period of continuous foreign service of not less than 91 days, that income will be exempt from Australian tax. The exemption will not apply where the foreign income is exempt from foreign tax in the overseas country because of:

- a “double tax agreement” or law of the country that gives effect to a double tax agreement;
- the foreign country does not tax employment income; and
- a law or an international agreement dealing with privileges and immunities of diplomats or consuls or of persons connected with international organisations applies.

Thus, the only situations where a tax liability will arise are where the service does not constitute “foreign service”, the employment period does not exceed 91 days or where the income is exempt in the country of origin.⁷⁵

In summary, although s 23AG does not limit the scope of the primary residency tests (ie the jurisdictional, claim), the effect of s 23AG, from a practical viewpoint, is to remove the need to resolve questions of cessation of residency for some foreign employed taxpayers (ie, those residents engaged in foreign service without other Australian taxable income).

74 Explanatory Memorandum, Taxation Laws Amendment (Foreign Tax Credits) Bill 1986 (Cth), 22. Section 23AG replaced the former s 23(q) of 1936 Act, which exemption most foreign income (including foreign salary and wages) provided it was liable to tax in country of source.

75 The foreign service requirement can be difficult to satisfy as illustrated in the Full Federal Court decision in *Chaudhri v Commissioner of Taxation* (2001) 47 ATR 126; 2001 ATC 4214 where a taxpayer who was employed as a merchant seaman aboard a Panamanian ship was not exempt under s 23AG on income earned despite spending more than 91 days in foreign seas. He failed to satisfy the Court that his employment was foreign service income earned in a “foreign country”. The Court noted that whilst the dictionary definition of “country” could contemplate inclusion of the high seas, the ordinary English use of the word would be a political entity capable of imposing income tax law.

2 Alternative definitions in the income tax law

As well as using the common law concept of “residency” in the 1936 Act, there are three other specific purpose residency definitions used (or intended to be used) in the income tax law: “ordinarily resident”, “Territory resident” and “temporary resident”. There is also the term “foreign resident”, which is defined in s 995-1 of the 1997 Act to be someone who is not a resident of Australia under the 1936 Act. As the term is merely the restitution of the concept of “non-resident” as discussed above, it will not be discussed in this context.

(a) Ordinarily resident

The term “ordinarily resident” is used in ss 23(a)(ii), 23(v), 23AA,⁷⁶ 128J(1)(b), 251U(1)(e), 252(3)(b), 252A(2A)(b) of the 1936 Act and in number of DTAs.⁷⁷ The term “ordinarily resident” has a slightly different meaning to the term “resident”. The term is equivalent to the United Kingdom term “ordinary resident”.⁷⁸

The United Kingdom courts have explored the differences in meaning between the terms “resides” and “ordinarily resident”.⁷⁹ Viscount Cave LC in *Levene*⁸⁰ stated that the words “ordinary resident” “. . . connotes residence in a place with a degree of continuity . . . apart from accidental or temporary absences”. This view was supported by others like Lord Sumner in *Lysaght*⁸¹ who stated that “. . . the converse to ‘ordinarily’ is ‘extraordinarily’ and that part of the regular order of a man's life, adopted voluntarily and for a settled purpose, is not ‘extraordinarily’”.

76 Section 23AA was enacted in *Income Tax and Social Services Contribution Assessment Act (No 2) 1963* (Cth). It included the concepts of “Australian citizen” and “ordinarily resident”.

77 It is used in respect in the “Government Remuneration Article” in the German (arts 17(2)), 1968 United Kingdom (art 15(1)), French (art 18(2)) and Japan (art 14(2)) DTAs, in the “Residency” Article in the South African (art 3(1)(c)) and 1968 United Kingdom (art 3(1)(c) and (d)) DTAs, and in the United States DTA (art 1(4)(b)) to limit scope of Articles 19 (Governmental Remuneration), 20 (Students) and 26 (Diplomatic and Consular Privileges).

78 The terms “ordinary” and “ordinarily” resident are used interchangeably in United Kingdom tax legislation. The origins the “ordinary” resident term lie in early United Kingdom tax legislation – see United Kingdom, *Report of the Income Tax Codification Committee* Cmd 5131 (1936), 38.

79 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774; 4 ATD 397; 1 AITR 201; *Inland Revenue Commissioners v Lysaght* (1928) 13 TC 511 (Lord Sumner) and *Inland Revenue Commissioners v Coombe* (1932) 17 TC 405, 410 (Lord Clyde).

80 *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, 507.

81 *Inland Revenue Commissioners v Lysaght* (1928) 13 TC 511.

In Canada, Justice Rand in *Thomson v Minister of National Revenue* agreed stating that the term “ordinary resident” carries a restrictive signification and means “. . . residence in the course of the customary mode of life of the person concerned, and is contrasted with special or occasional or casual residence.”⁸² Thus, the term is equated with habitual residence. This is further illustrated in cases where a person who is not “resident”, having left a country for work purposes⁸³ or for military service,⁸⁴ is found to be “ordinary resident” in that country.

As a result of the United Kingdom precedent the concept of “ordinary resident” is expanded in those sections. Thus, a person may be deemed to be “ordinarily resident” in Australia in the context of s 23AA of the 1936 Act, through the mere availability of living accommodation in Australia (ie the “place of abode” test).⁸⁵ However, it is interesting to note that the place of abode test only has had limited operation in the United Kingdom since 1993 due to subsequent statutory override.⁸⁶

(b) Territory resident

The “Territory resident” test exists in Division 1A of Part III of the 1936 Act. Division 1A exempts Norfolk Island residents from tax on income derived from sources in and outside of the Territory (including Australia).⁸⁷ As well, a non-territory resident individual who derives income from an office or employment is also exempt on that income if the Commissioner is satisfied that the individual intends to remain in that Territory for a continuous period of more than six months.⁸⁸

The purpose of the Division 1A is to safeguard against exploitation of the tax exempt status of Territory residents by persons not resident in the Territory. Under s 24C of the 1936 Act, a “Territory resident” is defined as a person, other than a company, who “resides” and has his or her “ordinary place of residence” in a prescribed territory,⁸⁹ and

82 *Thomson v Minister of National Revenue* [1946] DTC 812, 815.

83 *Cohen v Commissioner of Inland Revenue* (1946) 13 SATC 362.

84 *Slater v Commissioner of Taxes* [1949] NZLR 678; 4 AITR 249; 9 ATD 1.

85 *Cooper v Cadwalader* (1904) 5 TC 101 and *Attorney-General v Coote* (1817) 4 Price 183; abstract published in (1887) 2 TC 385.

86 *Finance Act 1993* (UK), s 208. This is illustrative of the dangers of using definitions importing from other jurisdictions, as the words can bring with them the associated interpretations without importing the safeguards of any later legislative override.

87 1936 Act, ss 24F and 24G(1)(a) to (d).

88 1936 Act, s 24G(1)(e).

89 Under s 24BB of the 1936 Act Norfolk Island is a prescribed territory.

would not be a resident of Australia, but for Norfolk Island being deemed to be subject to the operation of the Act (via s 7A(2) of 1936 Act) (ie it excludes persons who are also Australian residents in terms of various residency tests).

As the definition incorporates the “resides” concept, its scope is *prima facie* the same as that of the resides test in s 6(1) of the 1936 Act (see previous discussion in Part II A 2). However, given that residence is only one part of the test it is not clear to what extent the “resides” concept is qualified by the term “ordinary place of residence”. This uncertainty is due in part to the fact that what constitutes an “ordinary place of residence” is not defined.⁹⁰

The term “ordinary place of residence” may be equivalent to “ordinarily resident”. However, this is unlikely as usage of both terms is incompatible since the term “ordinarily residence” describes a lesser form of attachment to a country than “residence”. An alternative interpretation is that given that the Part is intended to only provide tax exemption for persons who genuinely live in the territory, the words “ordinary place of residency” may impose a physical residence requirement (ie requires a place of residence (home or apartment) in the Territory).⁹¹ Although this later interpretation is supported by extrinsic material, the actual meaning remains unclear.

(c) Temporary resident

The term “temporary resident” does not currently exist in Australian tax law. However, the term was contained in two 2002 tax Bills seeking to enact a series of concessions for expatriates working in Australia.⁹² Therefore, a brief discussion of its scope is useful as it is illustrative of the tendency for drafters to create specific purpose residency rules to ensure that the scope of the measures is limited to a narrower group than those caught under the general residency definitions.

90 Explanatory Memorandum, Income Tax Assessment Act (No 4) 1973 (Cth), 7.

91 Explanatory Memorandum, Income Tax Assessment Act (No 4) 1973 (Cth), 1 and Commonwealth, *Second Reading Speech*, House of Representatives, 30 August 1973 (Frank Crean, Treasurer), reproduced in Butterworths, *Taxation Laws of Australia: Legislation and Official Explanations (1972-1974)*, vol 6, 395.

92 The concept of “temporary residents” was included in both the *Taxation Laws Amendment (No 4) Bill 2002 (Cth)* (introduced on 30 May 2002) and *Taxation Laws Amendment Bill (No 7) 2002 (Cth)* (introduced on 23 October 2002) as part of a reform of expatriate taxation. However, due to

Under these proposed rules a “temporary resident” was to be defined in s 995-1 of the 1997 Act to be an individual who has not been resident in Australia at any time during the 10 years before becoming a resident, has not been a resident for more than 4 years, holds a temporary visa, and has not applied for a permanent visa. Special rules applied to New Zealand citizens.

In summary, in the limited circumstances mentioned above, the principal residency rules for individuals in s 6(1) of the 1936 have been modified.

3 *Other residency definitions in related tax acts*

There are also other definitions of “resident” in *Income Tax Rates Act 1986* (Cth)⁹³ and in the *Health Insurance Act 1973* (Cth) which modify the scope of the operation of tax and tax related (eg Medicare levy) laws.

First, a “resident taxpayer” is defined in s 3(1) of *Income Tax Rates Act* as someone who is not a “prescribed non-resident”, this being defined to be all non-residents except non-residents who receive a benefit under certain Acts (including the *Social Security Act*). This means that in certain circumstances, a non-resident who receives government benefits (eg a payment under the *Social Security Act 1991* (Cth)) is taxed at resident rates.

Second, an “Australian resident” is defined in s 3(1) of the *Health Insurance Act 1973* (Cth) to mean “a person who resides in Australia and who is . . . an Australian citizen”, a New Zealand citizen who is lawfully present in Australia, a person who has been granted an entry permit in force under the *Migration Act 1958* (Cth) or in limited circumstance, a person who holds temporary entry permit.

As a result, in some limited circumstances a person may be liable to pay the Medicare levy⁹⁴ but may not be eligible for Medicare benefits,⁹⁵ while others will have eligibility

the opposition parties in the Senate opposing the bills passage, the Government has abandoned the expatriate reform proposals – see discussion in Chapter 1, n 33.

93 See, eg, under s 3(1) of the *Income Tax Rates Act 1986* (Cth) there are seven residency definitions: “resident trust estate”, “resident beneficiary”, “resident taxpayer”, “non-resident trust estate”, “non-resident beneficiary”, “non-resident taxpayer” and “prescribed non-resident”. Only the “resident trust estate” definition has any consistency with the 1936 Act.

94 Section 251S(1)(a) of the 1936 Act imposes the Medicare levy on the taxable income of an individual who at any time during the year of income was a resident of Australia. The Medicare

for Medicare benefits but no Medicare levy is payable.⁹⁶ Thus, illegal immigrants and persons who have overstayed their legal time limit (prohibited non-citizens), temporary residents and persons merely visiting Australia⁹⁷ may be liable for Medicare levy as they are deemed residents under the 183 day test in s 6(1) of the 1936 Act,⁹⁸ but would not normally be “Australian residents” under the *Health Insurance Act* and would therefore be ineligible for Medicare benefits.⁹⁹

In summary, although the principal residency rules for individuals in s 6(1) of the 1936 Act is not modified by these two definitions, their existence creates another level of compliance that must be addressed.

C. Defining the impact of tax treaties on the domestic residency test for individuals

Finally, before the operation of the four tests can be evaluated against the objective criteria, it is important to explore the impact of bilateral tax treaties. The examination of DTAs will be done in two parts: first by establishing the context in which DTAs operate and second, by exploring the application of DTAs to residency and the application of the tie breaker tests in detail.

levy is not payable under s 251T(a) by a person who was a “prescribed person”. Section 251U(1) defines a “prescribed person” as one who is either a member of the Defence forces, or receives specific pension under either the *Social Security Act 1991* (Cth) or the *Veterans' Entitlements Act 1986* (Cth) or the head or member of staff of a diplomatic mission or consular post established in Australia, or a member of the family of such persons, provided they are not Australian citizens and not ordinarily resident in Australia.

95 As s 10(1)(a) of the *Health Insurance Act 1973* (Cth) only gives a Medicare benefit for medical expenses that are incurred in respect of a professional service rendered in Australia to an “eligible person”, persons who are not eligible do not get the benefit. Under s 3(1) an “eligible person” means an Australian resident or an “eligible overseas representative”. An “eligible overseas representative” is a head or member of staff of a diplomatic mission or consular post established in Australia, or a member of the family of such persons, provided they are not Australian citizens nor a person domiciled in Australia but who, under an agreement between the Government of the Commonwealth and the Government of that other country, is to be treated, for the purpose of the provision of medical, hospital and other care. See also Taxation Ruling IT 2615, *Income Tax: Medicare Levy - Test for Australian Residency - Payable by Australians Living Overseas and by Visitors to Australia*, para 23.

96 Ibid IT 2615, para 18.

97 Subject to any declaration that the Minister might make under s 6(1) of the *Health Insurance Act 1973* (Cth). Section 251U(1)(f) of the 1936 Act provides that a person whom the Minister for Community Services and Health has certified under subsection 6(1) of the *Health Insurance Act* to be ineligible for Medicare benefits in respect of medical services, or free treatment and care in a public hospital, is exempt from the levy.

98 Generally, a person visiting Australia for a short period whose usual place of abode is outside Australia is treated as a non-resident for income tax purposes and is not liable for the levy - IT 2615, above n 95, para 21.

99 Ibid para 13.

However, it is important to note that bilateral tax treaties take a number of forms. There are the wider agreements (eg DTA/Double Tax Conventions (DTCs)), more narrowly focused agreements (eg Airline Profit Agreements and Superannuation Double Coverage Agreements) and agreements to update terms in existing agreements (eg Protocols). As the focus of this examination will be on DTAs/DTCs, and the Protocols that update them, the term “DTA” will be used as a short hand title for these various agreements.

1 Context

In order to fully understand the impact of DTAs upon the domestic residency rules it is important in turn to put the operation of bilateral tax treaties in context by looking at the role of tax treaties and how they are interpreted. This examination will form the basis for further detailed examinations of treaty provisions in this and subsequent chapters.

(a) Role of Tax Treaties

As mentioned above, in order to avoid double taxation, bilateral agreements exist between Australia and other countries.¹⁰⁰ Double tax can arise as a consequence of the operation of the residency tests and of similar tests in other jurisdictions, as the interaction of the tests result in a person having more than one place of residence (ie dual residency).¹⁰¹ The double taxation arises if both Australia and the foreign jurisdiction claim the right to tax that dual resident's income.¹⁰² Double taxation can also occur where a taxpayer is a non-resident deriving income with an Australian source or a resident deriving income with a foreign source.

Thus, these agreements operate by countries (referred to as “contracting states”) agreeing to limit their rights to tax in respect of taxpayers and transactions in their jurisdictional

100 As at 31 July 2003 Australia had bilateral tax treaties with 43 countries, consisting of 42 comprehensive agreements and four airline profits agreements. This includes the Mexico DTA and the revised 2002 United Kingdom protocol contained in the *International Tax Agreements Amendment Act 2003* (Cth), assented to on 5 December 2003. As all treaties, including DTAs, are not automatically operational upon ratification, they require Australian legislative incorporation (*Koowarta v Bjelke-Petersen* (1982) 153 CLR 168). DTAs are incorporated into the domestic law as Schedules to the *International Tax Agreements Act 1953* (Cth).

101 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774, 778; 4 ATD 397, 399; 1 AITR 201, 202.

102 See, eg, *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82; 78 ATC 4486. The 1975 Asprey Committee noted that “... the resulting competition of jurisdiction to tax must be accepted and adjusted where possible by appropriately drafted provisions of double taxation agreements” - Taxation Review Committee, Commonwealth, *Full Report* (1975) 254-5.

claim. This is achieved by the contracting states apportioning their rights to tax.¹⁰³ Australia's DTAs generally follow the OECD Model Conventions.¹⁰⁴ Under the OECD Model Conventions the country of residency has the right to tax unless the transaction is closely associated with the economic activity of the source country.¹⁰⁵

As a result of the sharing of the taxing rights, many of the treaty provisions may be inconsistent with those of the 1997 Act. To overcome this problem, s 4(2) of the *International Tax Agreements Act 1953* (Cth) states that the treaty provisions prevail, except where the general anti avoidance provision (Part IVA of the 1936 Act) or specific tax credit limitation provisions (s 160AO of the 1936 Act) have operative effect. Conversely, many treaties give Australia the right to tax certain receipts, which are not taxable under the 1997 Act. For example, the 1997 Act does not tax exempt income, although such income could fall within the terms of the business profits article in many Australian treaties. Thus, the existence of a right to tax in a treaty does not result in the amount being taxed in that state unless there is domestic law that catches that amount.¹⁰⁶

(b) Interpretation of DTAs

DTAs are international agreements that are normally “. . . interpreted in accordance with the rules of interpretation recognised by international lawyers”.¹⁰⁷ The High Court in *Thiel v Federal Commissioner of Taxation* found that the Vienna Convention on the

103 The rights to tax can be exercised either solely by one contracting state or shared. Sole rights are usually exercised in respect of personal service income, whilst shared rights exist in respect of property income, such as interest, dividends and royalties.

104 Until 1992 there were three model OECD treaties - OECD, *Draft Double Taxation Convention on Income and Capital* (1963) (1963 Model); OECD, *Model Double Taxation Convention on Income and Capital* (1977) (1977 Model) or the OECD, *1992 Model Tax Convention on Income and Capital* (1992) (1992 Model). Attached to each model was a commentary on its operation (1963 OECD Commentary, 1977 OECD Commentary and 1992 OECD Commentary respectively). The 1992 Model has been regularly subjected to minor amendments and adjustments, with five versions published. The latest version, the *Model Tax Convention on Income and Capital 2003* (2003 Model) and commentary (2003 OECD Commentary), has operation from 28 January 2003.

105 Gzell (1996), above n 11, 14.

106 See *Federal Commissioner of Taxation v Lamesa Holdings BV* (1997) 36 ATR 589, 592; 97 ATC 4752, 4755. The converse can apply with income exempt in one jurisdiction being taxable in the other – see *Enoch v Federal Commissioner of Taxation* (2002) 51 ATR 1014; 2002 ATC 2201.

107 *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338; 21 ATR 531; 90 ATC 4717 (McHugh J). See also *James Buchanan and Co Ltd v Babco Forwarding and Shipping (UK) Ltd* [1978] AC 141 and *Shipping Corporation of India Ltd v Gamlen Chemical Co (A/asia) Pty Ltd* (1980) 147 CLR 142 cited in Tom Magney, *Australia's Double Tax Agreements: A Critical Appraisal of Key Issues* (1994) 8. The ATO's approach to interpreting DTAs is set out in Taxation Ruling TR 2001/13, *Income Tax: Interpreting Australia's Double Tax Agreements*. Also see Richard Vann, 'Tax Treaties in the 1990s' (Paper presented at the Taxation Institute of Australia's 3rd National Tax Retreat, Coolumb, 24-26 August 1995), 6-10 and *Cahiers de Droit Fiscal International: Interpretation of Double Taxation Conventions*, Vol LXXVIIa (1993).

Law of Treaties allowed the court to have recourse to the OECD Model Convention and Commentary as a means of providing guidance to the meaning of terms used by the contracting states in the DTAs.¹⁰⁸ It did not matter that the Model Convention and Commentary was not actually used in the treaty negotiation but:

. . . the relevant rules which it lays down are applicable, being no more than an endorsement or confirmation of existing practice: *Commonwealth v Tasmania* (Tasmanian Dam Case) (1983) 158 CLR 1 at 93-4, 222; 46 ALR 625; *Fothergill v Monarch Airlines Ltd* [1981] AC 251 at 276, 282. . .

they are documents which form the basis for the conclusion of bilateral double taxation agreements of the kind in question and, as with treaties in *pari materia*, provide a guide to the current usage of terms by the parties.¹⁰⁹

As a result, in order to understand the scope of these tests the principal resource is the Model Conventions and Commentaries.¹¹⁰ However, where a term is not defined in the Commentary it shall “. . . have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies,”¹¹¹ unless a contrary intention exists.

This may explain why the Explanatory Memorandum to the Bills, introducing the Australian DTAs, are generally of little assistance in interpreting the DTAs. Except for the 1968 United Kingdom and the Singapore DTAs¹¹² all other tax treaties entered into from 1974 until 1995 did not even describe the residency tie breaker tests in the treaties, let alone seek to clarify the intended scope of the provision.¹¹³ Since 1995 there have

108 *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338; 21 ATR 531; 90 ATC 4717.

109 *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338, 349-50; 21 ATR 531, 536-7; 90 ATC 4717, 4722-3 (Dawson J).

110 See also J F Avery Jones et al, 'Dual Residence of Individuals: the Meaning of the Expression in the OECD Model Convention – I' [1981] *British Tax Review* 15, reproduced in (1982) 16 *Taxation in Australia* 818 and J F Avery Jones et al, 'Dual Residence of Individuals: the Meaning of the Expression in the OECD Model Convention – II' [1981] *British Tax Review* 104, reproduced in (1982) 16 *Taxation in Australia* 905. Garth Harris, *New Zealand's International Taxation* (1990) 60 notes that as many terms in the DTAs do not appear in New Zealand's domestic law, there is little option other than to adopt the treaty interpretation.

111 2003 Model, above n 104, Art 3.2.

112 Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1968 (Cth) UK, 31-34; and Explanatory Memorandum, Income Tax (International Agreements) Amendment Act 1969 (Cth) Singapore, 7 which refers to the United Kingdom DTA description.

113 See, eg, Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1974 (Cth) Germany, 6; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1976 (Cth) Netherlands, 11 and France, 24; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1977 (Cth) Belgium, 8; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1980 (Cth) Philippines, 39 and Swiss, 51; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill (No 2) 1980 (Cth) Canada, 8; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1981 (Cth) Malaysian, 11 and Sweden, 26; Explanatory Memorandum, Income Tax

been changes, with the Explanatory Memorandum in respect of new or revised DTAs entered into between 1995 and 2000 listing the tie breaker tests. However, these Memorandum provide little information on the scope of these tie breaker tests.¹¹⁴ Since 2002 the information contained within Explanatory Memorandum has expanded.¹¹⁵

Another uncertainty in interpretation of DTAs arises from the fact that as there have been a number of OECD Model Conventions and the Models introduced since 1992 are being constantly updated.¹¹⁶ As a result of these changes, there is much debate about which version of the OECD Commentary on the Model Convention should be used when interpreting a DTA. Although there is support for using the version of the Commentary existing at the time the DTA was negotiated,¹¹⁷ the OECD Committee on Fiscal Affairs believes “. . . that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries even though the provisions of these conventions did not yet include the more precise wording . . .” of later Models.¹¹⁸ The

(International Agreements) Amendment (No 2) Bill 1981 (Cth) Denmark, 9; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1983 (Cth) USA, 18, Ireland, 38, Italy, 51, Korean, 65 and Norway, 80; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1984 (Cth) Malta, 17; Explanatory Memorandum, Taxation Laws Amendment Bill (No 3) 1985 (Cth) Finland, 58; Explanatory Memorandum, Taxation Laws Amendment Bill (No 3) 1986 (Cth) Austria, 58; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill (No 2) 1989 (Cth) Papua New Guinea, 36 and Thailand, 53; Explanatory Memorandum, Taxation Laws Amendment (International Agreements) Bill 1990 (Cth) China, 14, Sri Lanka, 34 and Fiji, 56; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1991 (Cth) Hungary, 17 and Kiribati, 37; Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill (No 2) 1991 (Cth) India, 13 and Polish, 47; and Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1992 (Cth) Indonesian, 17, Vietnamese, 58 and Spain, 96 (citizen test mentioned at 97).

114 The 1995 – 2000 Explanatory Memorandum tended to merely repeat the word of the Article (see, eg, Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1995 (Cth) New Zealand, 14-16; Explanatory Memorandum, International Tax Agreements Amendment Bill 1995 (Cth) Czech Republic, 16; Explanatory Memorandum, Taxation Laws Amendment (International Tax Agreements) Bill 1996 (Cth) Taipei Economic and Cultural Office, 14; Explanatory Memorandum, International Tax Agreements Amendment Bill 1999 (Cth) South Africa, 18, Slovak Republic, 67 and Argentina, 100; and Explanatory Memorandum, International Tax Agreements Amendment Bill (No 1) 2000 (Cth) Romania, 14).

115 See, eg, Explanatory Memorandum, International Tax Agreements Amendment Bill (No 1) 2002 (Cth) Russia, 18 and 19 and United States Protocol, 50; Explanatory Memorandum, International Tax Agreements Amendment Bill (No 2) 2002 (Cth) Canadian Protocol, 16 and 15 and Explanatory Memorandum, International Tax Agreements Amendment Bill 2003 (Cth) United Kingdom, 28 to 30 and Mexico, 97 to 99.

116 This is to ensure that the current Model reflects accurately the views of members at any point in time - 2003 OECD Commentary, above n 104, para 11 of Introduction.

117 *Crown Forest Industries Limited v The Queen* [1995] 2 SCR 802 and commentary by James Hausman, ‘Interpreting Tax Treaties - A Canadian Perspective’ (2001) 55 *Bulletin for International Fiscal Documentation* 93, 94.

118 2003 OECD Commentary on introduction, above n 104, paras 33-35.

courts have used later Model Commentaries, but usually only where the changes are minor and have no substantial effect on the outcome.¹¹⁹

For the purposes of this thesis the Commentary to be used in analysing the scope of the DTAs is the 2003 OECD Commentary.¹²⁰

2 DTAs in detail

(a) Application of DTAs to residency

DTAs do not normally concern themselves with the residency rules of the Contracting States or lay down the conditions under which a person is to be treated fiscally as “resident”.¹²¹ Rather, the residency concept in DTAs is of importance in:

- determining the scope of the DTA;
- solving cases where double taxation arises as a consequence of double residence, by providing a residency tie breaking test that determines which of the contracting states has primacy in respect of a taxpayer with dual residency; and
- solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs ¹²² by eliminating taxation in the source country; limiting taxation in the source country; and providing relief for tax paid in the source country.¹²³

All Australian DTAs, except for the Japan DTA,¹²⁴ contain residency tie breaker tests, usually located in Article 4. As each treaty comes into existence through negotiation the language of every treaty differs. The variation in many cases, however, is minor as all Australian Treaties since 1963 have been based upon the OECD Model Convention

119 See David Oliver, ‘Current Notes: Employees and Double Tax Agreements’ [1995] *British Tax Review* 529, 532, who illustrates the point by reference to *R v Inland Revenue Commissioners, ex parte Commerzbank AG* [1991] STC 271; BTC 161.

120 2003 OECD Commentary, above n 104.

121 Ibid, Commentary on art A, para 4.

122 Ibid.

123 *Thiel v Federal Commissioner of Taxation* (1990) 171 CLR 338, 357; 21 ATR 531, 542; 90 ATC 4717, 4727 (McHugh J). See Hamilton, above n 40, para 6.140.

124 Dual residency issues under the Japanese DTAs are dealt with through the competent authority procedures in art 20 - Hamilton, *ibid*. The 1946 United Kingdom and the 1953 United States DTAs did not contain tie-breaker tests for dual residents, rather tax credits were the means of granting double tax relief – see Memorandum, Income Tax Assesment Bill 1947 (Cth), 76 and Explanatory Memorandum, Income Tax (International Agreements) Bill 1953 (Cth), 54 respectively.

existing at that time.¹²⁵ Thus, although the language of the tie breaker tests vary, all the five tie breaker tests contained in Article 4(2) of the 2003 OECD Model Convention are represented in Australian DTAs.¹²⁶

The five tests set out in the Article 4(2) of the Model Convention apply in the following declining hierarchy, ie a taxpayer will be deemed to be resident:

- in a State in which the person has a permanent home available;
- if the person has a permanent home available in both States, then residency is in the State in which the person's personal and economic relations are closest (centre of vital interests);
- if the centre of vital interests cannot be determined, or there is not a permanent home available, then place of habitual abode is determinative;
- if a habitual abode is found in both States or in neither of them, place of residence will be determined by the person's nationality;
- but if the person is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.¹²⁷

Australia has been reluctant to adopt the OECD tie breaker tests. Only the 1995 New Zealand DTA¹²⁸ contains the first four of the above tests¹²⁹ in the above hierarchy,¹³⁰ and only two treaties have expressly adopted the mutual agreement tie breaker test.¹³¹

125 Above n 104.

126 2003 Model, above n 104.

127 Avery Jones (1981a), above n 110, 17 and 820, observe that by preferring criteria linked to permanent connection rather than arbitrary length of stay rules the Model gives “. . . taxpayers a better opportunity to seek a judicial or administrative resolution of the issue without resort to the mutual agreement procedure.”

128 For detailed analysis of the New Zealand-Australia DTA see Michael Dirkis, ‘Australia-New Zealand Tax Treaty’ (1995) 49 *Bulletin for International Fiscal Documentation* 583.

129 The four tests adopted are the availability of a permanent home in the State, the place of closer personal or economic relations, the place of habitual abode, and citizenship.

130 This is a change from the 1972 Treaty where the “place of habitual abode” had precedence over the “personal or economic relations” criteria. J McCormack and A Archer, ‘The New Australia/New Zealand Double Tax Agreement: A Review of the Critical Issues’ (Paper presented at the ATAX Second Annual International Tax Weekend Workshop, Sydney, 26-28 May 1995) para 2.2.3 claim that the relegation of the “place of habitual abode” test will make it more difficult for individuals to lose their original residency status under the Treaty than was possible under the 1972 Treaty.

131 Outside the Japan DTA, which (in absence of any tie breaker tests) relies on the competent authority, the 2000 Romania DTA was the first Australian DTA to contain an express mutual agreement tie-breaker provision, followed by 2003 United Kingdom DTA. Australia has traditionally opposed such clauses as it has historically believed residency is a matter of fact and should not be determined by competent authorities.

A finding of residency under tie breaker tests in most of Australia's DTAs only determines residency for the purposes of applying the other articles in that DTA. However, where a Dual Residency Article exists, a finding of residency under tie breaker tests gives the "resident" country the exclusive right to tax income arising in the country and to tax income arising in a third country.¹³²

The tie breaker test excludes from the definition of resident any person who is liable to tax in that state in respect only of income from sources in that state.¹³³ The Model Commentary indicates that the class of persons is foreign diplomatic and consular staff serving in their territory.¹³⁴ Thus, residents of Norfolk would not be residents under the agreement as they are exempted from tax on income from sources outside Australia.¹³⁵ This means the treaty partner is not estopped from taxing individuals whose income has not been subjected to tax in Australia. However, such a clause can cause a problem where the country taxes on a source basis, as no one qualifies as a resident.¹³⁶

(b) Examination of the tie breaker tests in detail

In order to understand the operation of the DTA tie breaker tests it is necessary to explore the scope of each tie breaker test and the interrelation between them. As the tests are principally objective and use terminology not generally in use in all jurisdictions,¹³⁷ the Model Commentary provides contemporary guidance on the meaning of the tests. The tests will be examined in the following order:

- Availability of permanent home test;
- Personal and economic relations test;

132 A dual residency Article is found in only nine of Australia's pre 1983 DTAs – Singapore art 16, Germany art 20, Netherlands art 22, France art 21, Belgium art 22, Philippines art 22, Switzerland art 21, Malaysian art 20 and Italy art 22. However, the dual residency Articles are not all the same and operate in two distinct ways. The dual residency Article in Singapore's DTA limits the tax exemption in the other territory only to the territorial tax and third country income that is subject to tax in the country of deemed residency. In the other eight DTAs the Article operates by reserving the right to tax, for the country of deemed residency, to the territorial and third country income.

133 Except for the Singapore DTA, which was based on the 1963 Model, above n 104. The change was needed to deal with the fact that Singapore taxes on a source basis - see Gzell (1996), above n 11, 16.

134 2003 OECD Commentary on art 4, above n 104, para 8.

135 1936 Act, s 24F.

136 Article 3 of the Singapore/Australia agreement ensures that income of Singapore residents not subject to tax, as being derived from sources outside Singapore, is not relieved of Australian tax - see Gzell (1996), above n 11, 15.

137 Avery Jones (1981a), above n 110, 22 and 824-5.

- Habitual abode test;
- Nationality test; and
- Mutual agreement

In undertaking this examination any variation away from the OECD Model in individual Australian DTAs will be highlighted in order to illustrate that there exists an underlying complexity arising from the failure by Australia to adopt standard OECD clauses in Australian DTAs.

(i) Availability of permanent home test

The principal test in the Model Convention for determining residency of an individual is the "availability of a permanent home". It is the principal test in all but two of Australia's DTAs.¹³⁸ In order to understand the scope of the test it is necessary to explore its three key elements: a "home", "permanent" and "availability for use".

First, a "home" is described in the Commentary to be any form of home and illustrates this by reference to "house or apartment belonging to or rented by the individual" and to a "rented furnished room".¹³⁹ It is argued that since the test is expansive, the use of words such as "house, apartment or rented furnished room" in the Commentary are merely illustrative of types of permanent dwellings as are the words "belonging to or rented". If the test was narrowly interpreted then houseboats or caravans would not qualify as permanent dwellings¹⁴⁰ and individuals could escape the test by merely renting a house in the name of a private company¹⁴¹ or by having the property rented by a spouse with whom the individual cohabitated.¹⁴² It has also been argued that use of the word "home" is significant as it implies that elements of domesticity must exist.¹⁴³

138 The United States (2002) and Japan DTAs.

139 2003 OECD Commentary on art 4, above n 104, para 13. William Schofield, 'Expatriate Tax Issues: The Application of Double Tax Treaties in the Context of Australian Taxation' (Paper presented at the *Taxation Institute of Australia's 2001 Queensland State Convention*, Gold Coast, 18 May 2001) 4 notes that this reflects the practice of employers of inbound expatriates who provide accommodation (leased or owned) to their employees.

140 Schofield, above n 139, 4.

141 Avery Jones (1981a), above n 110, 22 and 824-5.

142 Ibid 29 and 831.

143 Garth Harris, above n 110, 61. This inference is drawn from the use of the word in the domestic law of countries such as New Zealand (the former "home" test in the *Income Tax Act 1976* (NZ) s 241) and France (the habitual abode ("foyer") test under administrative and traditional case law).

Second, the concept of “permanence” is crucial under the test. In order to satisfy the test the person must own or possess a home and “. . . must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.”¹⁴⁴ Occasional availability for the short periods associated with “travel for pleasure, business travel, education travel, attending a course at a school” will not satisfy the permanence requirement.¹⁴⁵

Finally, it is essential that the dwelling be available to the person at all times continuously,¹⁴⁶ ie it cannot be leased in the individual’s absence. Thus, the availability of a holiday home kept available permanently may also satisfy the test.¹⁴⁷

Australia has generally adopted in DTAs the permanent home test as its primary tie-breaker test. The only variation is found in the 2002 United States DTA where the test is expressed in terms of “maintenance” of a permanent home rather than “availability”. Article 4(2) of the United States DTA also requires that “regard shall be given to the place where the individual dwells with his family”. Thus, this test is harsher than the “availability” test as maintenance of residence is required, not just availability. It is difficult to establish the existence of a “permanent” home if the individual resides elsewhere.

(ii) Personal and economic relations test

The second tie breaker test is “personal and economic relations” test. Where an individual has a permanent home in both Contracting States, the place of residency is the State with which the personal and economic relations of the individual are closer (ie the centre of vital interests).¹⁴⁸ Australian treaties tend to use the words “personal and economic relations” or “economic and personal relations” rather than “centre of vital interests”.¹⁴⁹

144 2003 OECD Commentary on art 4, above, para 12.

145 Ibid, para 13

146 Ibid.

147 Avery Jones (1981a), above n 110, 25 and 826.

148 2003 OECD Commentary, above n 104, art 4, para 14. It is suggested that the reason for linking permanent home and vital interests tests is that it is unlikely that someone would have vital interests in a place without having a permanent home there – Avery Jones, *ibid* 107 and 908.

149 The term “centre of vital interests” is used in conjunction with “economic and personal relations” in the Indian, Hungarian and United Kingdom (2003) DTAs.

The Commentary notes that in order to ascertain to which of the two States the person's personal and economic relations are closer, regard must be had “. . . to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole.”¹⁵⁰ Where there are conflicts between place of economic interests and personal interests, the place of closer personal interests is preferred.¹⁵¹ Where a person with a home sets up a second home in another State, the person's centre of vital interest may not change, particularly if the person retains the first home “. . . in the environment where he has always lived, where he has worked, and where he has his family and possessions.”¹⁵²

Although Australian DTAs tend to adopt the “personal and economic relation” test, it is not always the second tier test. In 17 of the DTAs the “habitual abode” test (discussed next) is placed ahead of the “personal and economic relations” test.¹⁵³ Thus, the “personal and economic relations” test is only the second tier test in 24 of the DTAs.¹⁵⁴ The reasons for this departure from the OECD Model Conventions is unclear,¹⁵⁵ particularly given that a determination under “permanent home” and the “personal and economic relations” tests would incorporate consideration of the same criteria. Thus, the test is effectively otiose in these treaties.

(iii) Habitual abode

In the cases where the residence cannot be determined by reference to the centre of vital interests rule or there is not a permanent home in either State, the next step is the “habitual abode” test. Thus, where the individual has a permanent home available in both States, and the State with which the taxpayer had closer personal and economic relations is unknown then residency is in the State where the individual stays more

150 2003 OECD Commentary on art 4, above n 104, para 15.

151 Ibid.

152 Ibid.

153 The Australia's DTAs that rank the “habitual abode” test second are with Singapore (1969), Belgium (1977), Germany (1972), Malaysia (1980), Denmark (1981), United States (2002), Ireland (1983), Italy (1982), Papua New Guinea (1989), Thailand (1990), Fiji (1990), Kiribati (1991), Indonesia (1992), Sri Lanka (1992), Taiwan (1997), Poland (2000), and Slovak Republic (2000).

154 The “personal and economic relations” test is ranked second in the DTAs with France (1976), Netherlands (1976), Canada (1980), Philippines (1980), Switzerland (1980), Korea (1982), Norway (1982), Sweden (1982), Malta (1984), Finland (1984), Austria (1986), China (1988), India (1992), Hungary (1993), Spain (1993), Vietnam (1993), New Zealand (1995), Czech Republic (1996), Argentina (2000), Romania (2000), South Africa (2000), Russia (2002) United Kingdom (2003) and Mexico (2003).

155 Avery Jones (1981a), above n 110, 25 and 826.

frequently (a habitual abode).¹⁵⁶ In determining frequency regard is had to total presence at each permanent home.¹⁵⁷ Where the individual does not have a permanent home in either State and the State with which the personal and economic relations of the individual are closer is unknown (eg a person going from one hotel to another¹⁵⁸) then residency is in the State where the taxpayer spends the most time.

What the time period is for comparison under the test is not defined. The Commentary states that there is sufficient presence in time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.¹⁵⁹

The “habitual abode” test is not universally adopted in Australian DTAs, being found in only 20 of Australia’s DTAs either as an independent test, or as a gloss to the “personal and economic relations” test.¹⁶⁰ The continued use of the “habitual abode” test in Australian treaties negotiated since 1967, and its elevated position in 17 of those treaties is somewhat surprising given that the test is encapsulated in the higher level of attachment tests, the “permanent home” and “closer personal and economic relations” tests. However, this fact seems to have finally “dawned” on the Government given the non-inclusion of the “habitual abode” test in post 2002 DTAs (in the Russian, 2003 United Kingdom and Mexican DTAs) and recognition in the Explanatory Memoranda that “personal and economic relations” includes habitual abode.¹⁶¹

(iv) Nationality

Where it is impossible to determine a habitual abode, the residency will be in the State of which the individual is a national. This “fourth level” tie breaker test is rarely used as an independent tie breaker test (the exceptions being the 1995 New Zealand and the 2003 United Kingdom DTAs). The nationality test, which appears in 15 other Australian DTAs, is used as an element for determining the place of “habitual abode” or the place

156 2003 OECD Commentary on art 4, above n 104, para 17.

157 Ibid.

158 Ibid para 18.

159 Ibid para 19.

160 The “habitual abode” test is the second ranked test in the 17 countries listed above n 124 and in the New Zealand DTA (1995). It is also used as a gloss to the second ranked “personal and economic relations” test in the Norway (1992) and India (1992) DTAs.

161 See, eg, Russia Explanatory Memorandum, above n 115, 19 and the Mexico Explanatory Memorandum, above n 115, 99.

of “closest economic relations”.¹⁶² Again, it is not clear why Australia has departed from the OECD Model Convention and not used nationality as a tie-breaker. However, the use of the test as gloss may indicate that the Australian negotiators believe that the “closest economic relations” test encompasses nationality.

(v) Mutual agreement

Finally, if the individual is a national of both Contracting States or of neither of them, then it is up to the competent authorities to resolve the difficulty by mutual agreement according to the procedure established in Article 25. As mentioned above, only two of Australia's recent treaties include an express tie breaker test, which allows resort to a mutual agreement clause.¹⁶³ Why there is this reluctance to include one of the OECD tests is uncertain. It can only be assumed that Australian negotiators hold a view that a residency determination is ultimately factual, outside the scope of an administrative agreement.

(c) Summary

All but one of Australia's DTAs do provide a mechanism for resolving dual residency problems via a series of tie breaker tests. The effect of the DTA tie breaker tests is to limit the scope of the domestic residency tests where a dual resident individual is found to be more closely tied to the other contracting state. Thus, each DTA only impacts on Australia's jurisdictional claim (the residency rules) to remove double taxation in respect of a person who is a dual resident under the domestic law of both contracting states.

162 The “nationality” tie breaker test is used as a gloss to the “personal and economic relations” test in the DTAs with Malaysia (1980), Philippines (1980), United States (2002), Norway (1982), Korea (1982), Malta (1984), Thailand (1990), Fiji (1990), Sri Lanka (1992), India (1992), Spain (1993), Czech Republic (1996), Slovak Republic (2000), Russia (2002), and Mexico (2003). The “habitual abode” gloss is only used in the DTA with Norway (1982).

Article 4(1)(b)(ii) of the United States (2002) protocol confines the United States definition of resident under the treaty to a United States citizen, other than a United States citizen, who is a resident of a State other than Australia for the purposes of a DTA between that State and Australia. It also should be noted that Art 1(3) of United States DTA (2002) permits the United States to tax former “long-term residents” without regard to the treaty. This consistent the United States’ domestic “exit” rules - see discussion below in n 405.

163 Only the Romania DTA (2000) and United Kingdom DTA (2003) contain a mutual agreement provision in the tie breaker test.

Finally, as Australia's DTAs have been developed in the main over the last 35 years through country by country negotiation, the tie breaker tests adopted and the order in which they appear varies from DTA to DTA.

D. Summing up the scope of the residency tests for individuals

In summary, the residency tests for individuals are found in s 6(1) of the 1936 Act. They consist of the primary "resides" test and three extension tests (the "domicile" test, or the "183 day" test or the "Commonwealth superannuation" test). That hierarchy is not generally borne out in practice where the courts tend to apply the relevant extension tests in conjunction with the common law resides test.

To add to this matrix there are other specific residency tests that for specific purposes limit the scope to the general rules (eg, ordinarily resident and Territory resident) and other definitions also exist in related legislation (eg, *Income Tax Rates Act* and the Medicare levy).

The final piece of the puzzle is the residency tie breaker tests in DTAs, which have the effect of altering the scope of the domestic residency tests where a dual resident individual is found to be more closely tied to the other contracting state.

III Exploring the Main Thesis – Evaluating the effectiveness of the residency rules for individuals

The above overview of the individual residency rules reveals a complex matrix of imprecise and often subtly different rules. The purpose of this Part is to explore whether these rules fail, in their practical application, to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance. The evaluation will be undertaken by illustrating circumstances where the law struggles to satisfy each of the evaluative criteria. The evaluative criteria are addressed in the following order:

- equity;
- efficiency;
- simplicity; and

- the prevention of tax avoidance.

Where some examples illustrate that a number of the evaluative criteria are not satisfied, to avoid duplication in text and analysis, it is proposed to discuss them in the context of the more relevant evaluative criteria only, with a passing reference being made to the other shortcomings.

A. Equity

Consistent with the definition in Chapter 2, in determining compliance with the equity objective, the following discussion will highlight where individuals in similar circumstances are not being taxed similarly (horizontal inequity) or where the tax burdens do not fall upon those with the greatest ability to pay (vertical inequity). The approach to be adopted is to examine the residency rules more broadly, before focusing on specific equity issues in relation to the superannuation test in s 6(1) of the 1936 Act and the DTA tiebreaker tests.

1 “Facts and circumstance” tests (the resides, domicile, 183 day, ordinarily resident and territory resident tests)

Under the resides, domicile and 183 day tests in s 6(1) of the 1936 Act, and the territory resident test in s 24C of the 1936 Act an individual must determine, in light of the individual’s personal circumstances, whether he or she “resides” in Australia/Territory, has a “permanent” or “usual” place of abode, or even if she or he has the intention (objectively) to take up residency.¹⁶⁴ Similarly the ordinarily resident test also turns on the facts and circumstances of the individual taxpayer. As a result, an individual’s residency status under the resides, domicile, 183 day, ordinarily resident and territory resident tests rules can turn on a minor variation in circumstances or, hypothetically, even on a difference in a single fact.

¹⁶⁴ Although s 6(1)(a)(i) and (ii) requires that the Commissioner be satisfied that a “permanent place of abode is outside Australia”, or that a “usual place of abode is outside Australia” and there exists no intention to take up residency (respectively), s 169A of the 1936 Act allows the Commission can rely on a statement by the taxpayer in their return that these conditions exist. Section 169A(1) was enacted by *Taxation Laws Amendment Act 1986* (Cth) to facilitate the self assessment system, introduced for the year of income ended 30 June 1987 onwards.

Given that minor variations in a taxpayer's circumstances may determine residency it is possible that persons in similar circumstances could have different residency status. For example a different occupation can vary residence. A sailor is more likely to be found resident than an oil worker, who is absent from Australia for similar periods, due (as discussed above in Part II, A 2(a)(i)) to the discounting of importance of the "physical presence" element of residency by the Courts in respect of sailors. As horizontal equity is found where individuals in *similar circumstances* are taxed similarly (emphasis added), the individual "fact and circumstances" nature of these tests means that in application they fail to deliver horizontal equity.

2 The superannuation test

As discussed above, the superannuation test in s 6(1)(a)(iii) of the 1936 Act deems residency where a person is a member of either of two specified Commonwealth superannuation schemes (PSS or CSS). The rule also deems residency for that person's spouse and/or child less than 16 years of age.

The test also appears to lack horizontal equity (ie taxpayers in similar economic circumstances are not treated similarly) in two ways. As discussed in the following, it applies inconsistently to public servants and to the spouses and children of public servants.

(a) Inconsistent application to public servants

First, the test only deems some Commonwealth public servants to be residents, with the majority of government employees (including members of the defence forces¹⁶⁵, employees of Commonwealth statutory authorities and business enterprises, and university staff) escaping its net, as they do not belong to the two named schemes. It also fails its last stated policy purpose of including "... all Commonwealth public servants as residents".¹⁶⁶ As a result, the rules lack horizontal equity (ie taxpayers in similar economic circumstances are not treated similarly).

165 Defence force personnel are expressly excluded from the definition of "eligible employee" - *Superannuation Act 1976* (Cth) s 10.

166 Explanatory Memorandum, Taxation Laws Amendment Bill (No 2) 1992 (Cth) 181.

In fairness to the test, it was never intended to cover all government employees, nor even cover all Commonwealth public servants (as was mis-stated in an Explanatory Memorandum in 1992).¹⁶⁷ As mentioned previously, the purpose for the introduction of s 6(1)(a)(iii) was to “. . . bring within the Australian taxable field the salaries paid . . .” to *locally engaged* High Commission staff.¹⁶⁸ In response to questions in the House of Representatives concerning its scope he stated that the superannuation test was “. . . only designed to extend the provisions of the main act to those who are employed in the High Commissioner's office”.¹⁶⁹

In respect of subsequent amendments to the rules, necessitated by changes to the Commonwealth's superannuation scheme, governments have continually stated that the amendments did not alter the operation of, and the policy underlying, s 6(1)(a)(iii).¹⁷⁰ However, subsequent changes to the various Commonwealth superannuation schemes entitlement rules caused by changes to the public service's conditions of employment that resulted in removing eligibility for locally engaged overseas employees have in fact resulted in a policy change as the test can no longer achieve its original intention.¹⁷¹

As well as inequity between Commonwealth public servants, a similar inequity exists in respect of state/territory government employees. State/territory government employees posted to overseas missions, fulfilling similar duties to their Commonwealth counterparts, would not be deemed to be residents under this test.¹⁷²

Thus, in summary by only targeting a public servant who belongs to the two named schemes the rule does not deliver horizontal equity (ie taxpayers in similar economic circumstances are not treated similarly).

167 The Explanatory Memorandum erroneously states at 181 that the purpose for the introduction of the superannuation test was “. . . to include all Commonwealth public servants as residents.” Simply reading the Explanatory Notes, Income Tax Assessment Act 1930 (Cth), or the Second Reading Speech, Income Tax Assessment Act 1939 (Cth), would have avoided this error.

168 Spender, above n 67, 964

169 Spender, above n 67, 968.

170 See Second Reading Speech, Income Tax Assessment Amendment Bill (No 3) 1976 (Cth) and Explanatory Memorandum, Taxation Laws Amendment Bill (No 2) 1992 (Cth), 182.

171 See definitions of an “eligible employee” in respect of the *Superannuation Act 1976* (Cth) or a “member of the 1990 Superannuation fund”, above n 69 and 70.

172 However, they may be deemed to be residents under the domicile test, but only if a permanent place of abode is not found elsewhere. The purpose of the domicile test was to extend the scope of the Act to ensure that “. . . Agent-Generals for the Australian States together with members of their staffs, to be treated as residents” - Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10.

(b) Inconsistent application to spouses and children of public servants

Secondly, the test deems the spouse, or a child less than 16 years of age, of an eligible employee to be a resident, regardless of the degree of actual connection between the employee and his or her spouse and children. This element of the test can result in horizontal inequities in a number of ways. For example:

- if an Australian public servant, being a member of the named schemes, marries a foreign national, that person is deemed to be a resident of Australia even though they have no connection with Australia;
- if persons separate but do not divorce, and one spouse is a member of one of the named superannuation schemes, the other will remain a resident of Australia no matter where he or she actually resides. Further, he or she is unable to renounce their residency without a formal dissolution of the marriage, or their former spouse ceasing to be a member of the scheme; and
- a person taking an overseas posting, where his or her spouse was an eligible person for the purposes of the *Superannuation Act 1976* (Cth), would remain a resident¹⁷³ and be subjected to a greater rate of tax than a person on the same income who did not have a spouse who was an eligible employee.¹⁷⁴

Thus, the test is inequitable as its effect is to capture persons within the residency definition, who would not otherwise be residents, merely because they enjoy a familial relationship with a public servant who is eligible for membership of one of two named superannuation schemes.

The purpose for including the spouse and dependants of the taxpayer less than 16 years in the superannuation test in s 6(1)(a)(iii) was to entitle the High Commission officials to dependency deductions (now concessionary rebate tax offsets). This policy objective is no longer relevant as dependants are now deemed to be resident (by s 159J(3A) of the 1936 Act) for the purposes of the s 159J concessionary rebates, if their parent has an

173 See *AAT Case 13165 re Ardia and Federal Commissioner of Taxation* (1998) 40 ATR 1029; 98 ATC 2248, which illustrates the impact of deeming residency of a spouse merely because of the other spouse's membership of an eligible superannuation scheme.

174 John Passant, 'Residency: The Strange Case of the Commonwealth Superannuation Test' (1995) 7(5) *CCH Journal of Australian Taxation* 34. However, the Commissioner in a private ruling indicated that the strict application of this rule could be softened in some cases, see John Passant, 'The Commonwealth Superannuation Residency Test: An Update' (1996) 7(6) *CCH Journal of Australian Taxation* 28.

Australian domicile. Further, as such rebates have all but disappeared for most taxpayers, any minor advantages which may exist have been outweighed by the major problems it creates through its over reach.

The rule also appears to amount to discrimination based upon marital status.¹⁷⁵ Although such discrimination is not strictly illegal under the 1936 Act (and in particular this test¹⁷⁶), it is inconsistent with the intent of the United Nations *Convention on the Elimination of All Forms of Discrimination against Women*¹⁷⁷ and the *Sex Discrimination Act 1984* (Cth).¹⁷⁸

As in respect of public servants the domicile test lacks horizontal equity in that spouse and children of other Commonwealth, state and territory public servants, in similar economic circumstances, are not treated similarly.

175 However, mere financial disadvantage may not be sufficient to establish discrimination. The Tax Court of Canada in *Neil Barry McFadyen v Her Majesty the Queen* 2000 DTC 2473, 2488 found that provisions of the *Income Tax Act* RSC C 1985, 5th Supplement (as amended) did not contravene s 15(1) of the *Canadian Charter of Rights and Freedoms*, as a spouse of a diplomat posted abroad could not prove he was discriminated in the sense required by the Charter (ie “suffered prejudice, stereotyping and historic disadvantage or are subject to pre-existing disadvantage, vulnerability or prejudice”). He had merely suffered financial disadvantage.

176 The *Sex Discrimination Act 1984* (Cth) aims “to eliminate, so far as is possible, discrimination against persons on the ground of . . . marital status . . . in the areas of . . . the administration of Commonwealth laws and programs” (s 3(b)). However, although

- s 12 binds the Crown in right of the Commonwealth;
- s 26 declares that it “is unlawful for a person who performs any function or exercises any power under a Commonwealth law . . . to discriminate against another person, on the ground of the other person's . . . marital status;” and
- discrimination would occur under s 6 (as a determination under s 6(1)(i)(c) of 1936 Act “. . . is likely to have, the effect of disadvantaging persons of the same marital status”);

the Commissioner of Taxation's actions are exempted under s 40 (2)(c) (ie “Nothing in Division 1 or 2 affects anything done by a person in direct compliance with any of the following as in force on 1 August 1984: . . . (c) the *Income Tax Assessment Act 1936*”).

However, it is arguable that the exemption under s 40(2)(c) of the *Sex Discrimination Act* ceased as at 1 July 1997 with the enactment of the 1997 Act. The still operative 1936 provisions were incorporated via Schedule 1, s 2 of the *Income Tax (Consequential Amendments) Act 1997* (Cth) (which amends the definitions of “this Act”, “assessable income”, “exempt income” and “taxable income” in s 6(1) of the 1936 Act to refer to the “1997 Act”). Thus, as the residency test in s 6(1) of 1936 Act operate via incorporation into the 1997 Act, it is difficult to see how the exemption for the 1936 Act can continue to apply.

177 GA Res 34/180, UN GAOR, 34th sess, 107th plen mtg, 193, UN Doc A/Res/34/180 (1979). Article 9.1 of the convention states that “States Parties shall grant women equal rights with men to acquire, change or retain their nationality. They shall ensure in particular that neither marriage to an alien nor change of nationality by the husband during marriage shall automatically change the nationality of the wife, render her stateless or force upon her the nationality of the husband.”

178 The United Nations *Convention on the Elimination of All Forms of Discrimination against Women* is incorporated into Australian law via the *Sex Discrimination Act 1984* (Cth).

3 Problems caused by interrelationship of DTAs

Finally, a lack of horizontal equity inherently exists from the existence of DTAs, as only residents of the States that are parties to the treaty can avail themselves of the DTA tie breaker test. As a result some dual resident migrant individuals in a DTA country will be treated differently to those dual resident individuals from non-DTA countries.

As a result some individuals from countries that are a major source of Australia's migrant populations (eg Greece and Lebanon¹⁷⁹) face double taxation in the absence of treaties, particularly where both Australia and the country of income source claim taxation jurisdiction. This is illustrated by the facts *Federal Commissioner of Taxation v Efstathakis*.¹⁸⁰ Mrs Efstathakis, despite being taxable in Greece in respect of her Greek Press and Information Service salary income, was also taxable on that same income as a resident in Australia.

However, this is a natural consequence of the DTA process as the inequity only arises from obtaining equity for other taxpayers covered by DTAs. Further, this inequity is likely to be short term as the number DTAs is likely to increase, following the Government's 2003 announcement to escalate Australia's future treaty negotiation program.¹⁸¹

4 Summary

From the above discussion, it is evident that the residency tests for individuals, fail the horizontal equity evaluative criterion (ie where individuals in *similar circumstances* are not being taxed similarly). The rules fail to deliver horizontal equity as:

- the facts and circumstances tests (the resides, domicile, 183 day, ordinarily resident and territory resident tests) can result in persons in similar circumstances having different residency statuses;

179 In 2001 there were 116,431 people born in Greece and 71,349 born in Lebanon – see Australian Bureau of Statistics, Commonwealth, *2001 Census of Population and Housing* (2001) at URL: <http://www.abs.gov.au> as at 30 April 2004.

180 *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82; 78 ATC 4486.

181 Treasurer 'Review of International Taxation Arrangements' (Press Release No 32, 13 May 2003), Attachment E. These announcements arose from recommendations by Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999), recommendations 22.21 to 22.24; Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper*

- the superannuation test creates different residency outcomes for CSS and PSS members and their families when compared to other public servants in similar overseas postings; and
- dual resident individuals covered by a DTA are treated differently to dual residents who are not covered by a DTA.

B. Efficiency (Neutrality)

In light of the discussion in Chapter 2, the efficiency (neutrality) objective is satisfied if the rules relating to residency of individuals give rise to distortions such as a taxpayer being taxed differently due to the market in which the taxpayer operates (eg physical or electronic).¹⁸²

The principal residency rules in s 6(1) of the 1936 Act (common law, domicile, 183 day and superannuation tests), the specific tests (ordinarily resident and Territory resident) and the tie breaker tests do not treat an individual differently because they operate in either the physical or electronic markets. However, as illustrated in Part III D, these rules are able to be manipulated to minimise or avoid tax. Thus, there is a lack of neutrality as a result of the distortion caused by or flowing from tax avoidance. Further, the developments in mass communications technology and the spread of the Internet on the residency rules¹⁸³ are more about the Internet increasing the number of people able to manipulate the rules rather than whether the rules give rise to distortions in application to markets or structures.

In summary, although the residency rules apply the same tests to persons regardless of their mode of conducting business, they are not efficient as distortions arise from tax avoidance through manipulation of the rules (see Part III D).

(2002), 41; and the Board of Taxation, *International Taxation: A Report to the Treasurer* (2003), Recommendation 3.7, 96.

182 OECD *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001), 10.

183 Australian Taxation Office, Commonwealth, *Tax and the Internet: Discussion Report* (1997), 45 (ATO's first Internet Report).

C Simplicity

In determining compliance with the simplicity objective, the following discussion will highlight the extent to which the residency rules for individuals in application are:

- not predictable;
- not proportional;
- not consistent;
- associated with the imposition of high compliance burdens;
- difficult to administer;
- not co-ordinated with other tax rules; or
- expressed unclearly.

As a number of these elements overlap, a single rule may satisfy a number of the elements. Where the overlap occurs the rule will be assessed against the most relevant evaluative element. The extent to which a rule satisfies these elements will determine the extent to which the rules will be considered to have failed the simplicity objective in that circumstance. The assessment will follow the order of evaluative elements above.

1 Predictability

The first element for judging simplicity is to determine whether in applying the residency rules for individuals, the results are predictable (ie it is easy to understand a rule's intended and actual scope).

The principal factor that influences predictability of the residency rules for individuals is that a person's residency depends upon their individual personal facts and circumstances.¹⁸⁴ As mentioned above in considering the equity evaluative criterion, an individual under the "resides", "domicile" and "183 day" tests in s 6(1) and the "Territory resident" test in s 24C of the 1936 Act must determine, in light of their personal circumstances, whether he or she "resides" in Australia/Territory, has a

¹⁸⁴ *Federal Commissioner of Taxation v Miller* (1946) 3 AITR 333; 73 CLR 93; 8 ATD 146.

“permanent” or “usual” place of abode, or even if she or he has the intention (objectively) to take up residency.¹⁸⁵

As illustrated in the analysis of these tests in Part II, finding where an individual resides under these tests is not as simple¹⁸⁶ as finding “. . . where he sleeps and lives.”¹⁸⁷ The determination of residency under these rules can turn on a single fact, resulting in an outcome in many circumstances that was difficult to predict. A symptom of the problems with predictability is that even the ATO is unable to give determinative public rulings (rather than guidelines) on the operation of these rules in respect of the majority of taxpayers.¹⁸⁸ Even the AAT and courts arrive at different conclusions as illustrated by the 2002 litigation involving the Estate of Mrs Subrahmanyam (discussed previously).¹⁸⁹

Similar difficulties apply in respect of the ordinarily resident test (which also turns on the facts and circumstances of the individual taxpayer). Although some tiers of the DTA tie breaker test also suffer from a lack of predictability (personal and economic relations, habitual abode and mutual agreement tests), they are balanced by more predictable tests (availability of permanent home and nationality tests).

Although the application of the residency rules is unpredictable¹⁹⁰ Gzell notes that as “. . . the notion of residency is based upon ordinary English usage . . . it is sufficiently broad to enable the Courts to grapple with endless factual differences.”¹⁹¹ Prebble agrees stating “[i]ndividuals are physical . . . and the legal concepts of residency relate them to another physical fact: a taxing jurisdiction.”¹⁹² Gzell sees the odd decisions as

185 As noted at n 164, although under s 6(1)(a)(i) and (ii) requires that the Commissioner be satisfied that “permanent place of abode is outside Australia” or that a “usual place of abode is outside Australia” and there exists no intention to take up residency (respectively), s 169A of the 1936 Act allows the Commission can rely on a statement by the taxpayer in their return that these conditions exist.

186 Alley (1995), above n 42, 48 notes that determining where a person resides may not have been much of a difficulty in 1876 in applying the obiter dicta of Huddleston B in *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88, 103; 1 Ex D 428, 452, but that is not the case today. Also see Davies, above n 45, 23-28 and *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, 528, where Viscount Sumner noted “. . . the words are plain and it is only their application that is haphazard and beyond all forecast.”

187 *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88, 103; 1 Ex D 428, 452.

188 ATO’s first Internet Report, above n 183, 100 and see the Preamble in both IT 2650, above n 51, and to the former IT 2607, above n 16.

189 Above n 23.

190 ATO’s first Internet Report, above n 183, 100.

191 Gzell (1996), above n 11, 8.

192 John Prebble, ‘Ectopia, Tax Law and International Taxation’ [1997] *British Tax Review* 383, 388. However, Prebble concedes that people’s mobility make it more difficult to refine residency rules to pure physical location.

illustrative of the point that the concept of residence is broad, “. . . capable of being applied to multifarious factual situations, albeit that the results of the concept may not always result in a decision which receives universal approbation.”¹⁹³ The flexibility of the rules¹⁹⁴ means that “. . . as society's perceptions change, so will the notion of residence.”¹⁹⁵ More prescriptive rules will impede the ability of the law to develop.

However, this flexibility must be weighted up against the need for predictability, particularly in a self assessment environment where the onus of determining a person's residency status lies with that individual.¹⁹⁶ On balance, the outcome under the resides, domicile, 183 day, territory resident, ordinarily resident and some tiers of the DTA tie breaker tests is, in many circumstances, difficult to predict.

2 Proportionality

The second element for judging simplicity is to determine whether the complexity of the residency rules is proportional to the complexity of the policy. If the law is more complex than the policy, then the law will fail this element of the simplicity criterion.

The policy underlying the residency rules, as articulated previously, is conceptually relatively simple. For example, the broad purpose of the s 6(1) “resides” test was to extend the scope of the 1936 Act to income derived outside Australia by persons who ordinarily live in Australia and by persons who, despite having retained foreign nationality, citizenship or domicile, have their usual place of residence in Australia.¹⁹⁷

Similarly the clear purpose of the domicile test (s 6(1)(a)(i) of 1936 Act) was to extend the scope of the Act to ensure that Commonwealth and State diplomats and members of

193 Gzell (1996), above n 11, and Gzell (1997), above n 11, 5 and 21 respectively.

194 Prebble, above n 192, 389 notes that as people's mobility make it more difficult to refine residency rules to pure physical location, jurisdictions in defining their residency rules have adopted physical facts, metaphysical facts (such as intention) and resort to formal, arbitrary criteria where dual residency occurs. Thus, “[t]he arbitrariness of residency rules results . . . from practical difficulty, not from conceptual impossibility.”

195 Gzell (1996), above n 11, 8.

196 A hybrid form of self assessment for individuals has operated in Australia since the 1986-87 income year. Under this system there is no checking, in most instances, of the return on lodgement. However, unlike the full self assessment regime applying to companies and superannuation funds, the Commissioner still calculates the individual's liability and issues an assessment notice. For a history of self assessment see Michael Dirkis and Michael Payne-Mulcahy, ‘Time for a change: Self assessment 14 years on’ (2002) 36 *Taxation in Australia* 417 and Peter Costello, Commonwealth, *Review of Aspects of Income Tax Self Assessment: Discussion Paper* (2004), 2-5.

197 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10.

their staffs were treated as residents,¹⁹⁸ while the purpose of the 183 day test (s 6(1)(a)(ii)) was to obviate the difficulties in establishing a person's residency in any country.¹⁹⁹ As discussed above, the other 1936 Act residency tests (superannuation test and the Territory resident test) also have relative straightforward policy objectives.

However, despite these fairly simple policy objectives the fact and circumstances approach adopted in the resides, domicile, 183 day and Territory resident tests makes these rules more complex than the underlying policy. Further, the "domicile" terminology is also conceptually complex as the underlying concepts are highly artificial.²⁰⁰ A finding of "domicile of origin" can result in persons, having left a place with no intention to return, being regarded as domiciled in that place as they had not formed the requisite intention to settle elsewhere.²⁰¹ It has far wider impact than merely deeming residency for Australian diplomats posted overseas.

The one exception to simple policy concepts is the use of the word "ordinarily resident" in the 1936 Act. Its use is reflective of a fine policy distinction on the lower levels of attachment required for the application of certain rules. As the distinction between the concepts of "resides" and "ordinarily resident" (as discussed above) is very subtle, the complexity of the policy objective is increased.

Thus, complexity arising from the fact and circumstances approach adopted in the resides, domicile, 183 day and Territory resident tests is disproportional, in general, to the underlying policy. These also fail this element of the simplicity criterion.

3 Consistency

The third element for judging simplicity is to determine whether the residency rules lack consistency (ie give rise to arbitrary distinctions). If the rules operate in a way that gives rise to arbitrary outcomes, then rules will be deemed to fail this element of the simplicity criterion.

198 Ibid, 10.

199 Ibid, 11.

200 Peter Whiteman et al (eds), *Whiteman on Income Tax* (3rd ed, 1988) 140.

201 Eg, persons living in the United Kingdom for periods of 35 and 39 years were found to have retained their domicile of origin in South Africa and Canada respectively - see *Buswell v Inland Revenue Commissioners* (1974) 49 TC 334 and *Inland Revenue Commissioners v Bullock* (1976) 51 TC 522.

The interaction of the residency rules and DTAs can, in limited circumstances, result in inconsistent treatment of diplomatic and consular representatives of foreign missions in Australia and their families when compared with other resident taxpayers. Under the resides test in s 6(1) of the 1936 Act such diplomats could be resident under Australia's domestic law as they have a physical presence in Australia and have a "settled or usual abode, to live, in or at".²⁰² If the diplomats are residents, then their private income sourced in Australia and capital gains made on investments in commercial undertakings in Australia would be assessable.²⁰³ Their official salary and offshore income remains exempt.²⁰⁴

As a result of this domestic residency determination, the diplomat is entitled to the residential tax free threshold. Further, any interest, dividends or royalties income derived from Australian sources is not taxed at the diplomat's marginal tax rate. As diplomats are residents of their home country under DTAs, such income is subject to a maximum tax rate limitation specified in the DTA (eg interest income is taxed at the maximum rate of 10 percent under most DTAs).²⁰⁵ Further, the diplomat may also be entitled to concessional rebates, as domestically they are residents.

Thus, the application of the residency rules under s 6(1) of the 1936 Act deliver inconsistency in treatment between foreign diplomatic and consular staff and their families when compared to other foreign nationals working in Australia.²⁰⁶

202 *Applegate v Federal Commissioner of Taxation* (1979) 9 ATR 899, 905; 79 ATC 4307, 4313.

203 Experience indicates that generally foreign diplomats and consular representatives qualify as residents of Australia for Australian income tax purposes during their period of service in Australia except where their posting to Australia is of a very short duration. The factors that lead to these conclusions are that most representatives are posted for a fixed term exceeding two years (some have been in Australia in excess of 10 years) and that most representatives establish homes in Australia, with their spouses and children. The children attend schools and in general they become part of the community.

204 Section 23(a)(ii) exempts diplomatic and consular representatives in Australia from all income tax, except on their private income having its source in Australia and capital taxes on investments made in commercial undertakings in Australia, by reference to the *Diplomatic Privileges and Immunities Act 1967* (Cth) s 7(4) and the *Consular Privileges and Immunities Act 1972* (Cth) s 5(4). Section 23(c)(iii) exempts income earned in the capacity of a representative of any government, or member of the entourage of that representative. This privilege does not extend to officers who are Australian citizens or permanent residents: *Morris v Federal Commissioner of Taxation* (1989) 20 ATR 1666; 89 ATC 5303.

205 If a bilateral tax agreement (DTA) exists between Australia and the diplomat's country, then the extent to which the diplomat's private income sourced in Australia or capital gains made on investments in commercial undertakings in Australia are assessable will be determined by the agreement.

4 Level of compliance burden

The fourth element for judging simplicity is to determine qualitatively the level of cost (the burden) imposed upon the individual taxpayer in complying with the law. If examples indicate that the compliance costs are high, the residency rule fails this element of the simplicity criterion.

As with the predictability element of the simplicity test, the principal factor that influences compliance costs arising from the residency rules for individuals is that a person's residency depends upon their individual personal facts and circumstances. These compliance costs are potentially incurred at both the individual and employer level in determining whether an individual is a resident.

An individual, in a self assessment environment must determine, in light of their personal circumstances, whether they are residents under the resides, domicile and 183 day tests in s 6(1) of the 1936 Act. In order to obtain certainty, taxpayers can seek a private binding ruling.²⁰⁷ Although the actual number of rulings requested related to residency is unknown, the size of the compliance burden can be gauged through the number of published ATO Interpretative Decisions (ATOIDs). ATOIDs are non-binding interpretative decisions, which in the main are derived from private rulings, which are issued to improve the accuracy and consistency of decision making in the ATO.

A search of the word “resident” on the ATOIDs section of the ATO website gives rise to over 500 hits.²⁰⁸ Further analysis of that data reveals that between 2002 and 2004 ATOIDs relating to residency of individuals accounted for between 9% and 15% of all ATOIDs released. If these percentages apply equally in the same proportion to private ruling requests, then the ruling requests relating to residency could be in excess of

206 There is also inconsistency on a broader policy front as Government's have sought to remove a number of concessions in respect of education and health for foreign diplomats and their families. Despite this approach the residency rules continue to deliver a revenue advantage.

207 *Taxation Administration Act 1953* (Cth), Part IVAA

208 URL at <http://www.ato.gov.au> located on 23 April 2004. Of the 2001 ATOIDs 58 resident hits (40 related to individuals (69%)), of the 1116 2002 ATOIDs 140 resident hits (101 related to individuals (72%)), of the 1135 2003 ATOIDs 181 resident hits (142 related to individuals (79%)) and of the 350 2004 ATOIDs 60 resident hits (54 related to individuals (90%)).

600.²⁰⁹ Given accountancy costs range from \$200 per hour upwards, the potential cost of such private ruling requests still represents a major compliance cost on individuals.

There are also compliance problems for employers who are required to withhold differing levels of tax instalments depending upon the residency status of the employee. So if a young person with a “foreign” accent and a backpack seeks employment in a bar, the bar owner in theory must try to determine that person's residency status. The existence of a tax file number is of no assistance to the bar owner as a person does not require Australian residency to obtain a tax file number. Potentially the employer incurs compliance costs as the residency status of the individual depends upon their facts and circumstances; it is not possible for employers to use a checklist to determine the residency status of potential employees.

In reality, many employers are ignorant of their obligations. The ATO also noted, in its 1997 report on taxation and the Internet, concerns about “. . . increased accidental non-compliance, as small to medium businesses engage in international trade and become subject to international taxation obligations with which they may not be familiar.”²¹⁰

Ironically, even the “continuous foreign service” exemption in s 23AG of the 1936 Act, which was introduced with the purpose of ensuring the administrative integrity of the foreign tax credit system by removing many small taxpayers from its operation,²¹¹ is difficult to apply and carries high compliance burdens. In May 2004 the Minister for Revenue conceded that “the process of determining if a taxpayer qualifies for a foreign employment exemption is currently demanding.”²¹² For example, each time that a break occurs in foreign service of more than 24 hours a taxpayer needs to calculate “absentee credits” (which are accumulated for each day of eligible service) in order to ensure they still meet the eligibility requirements.²¹³

209 Based upon 9% of the Private Binding Rulings issued to non-business individuals. In 2002-03 the ATO issued 7,631 Private Binding Rulings, 60% of which were issued to non-business individuals - see Review of Aspects of Income Tax Self Assessment: Discussion Paper, above n 196, 16.

210 ATO's first Internet Report, above n 183, vii.

211 Explanatory Memorandum to Foreign Tax Credits Bill, above n 74, 22.

212 Minister for Revenue and the Assistant Treasurer ‘Simplification of foreign employment exemption’ (Press Release C035/04, 11 May 2004).

213 The Minister (ibid) announced simplification of these rules from 1 July 2005, by clarifying what types of leave may count towards eligible service, and simplifying the calculation required to determine if other types of absences constitute a break in this eligible service. Thus, any accrued leave, other than long service leave, will be included in a taxpayer's period of foreign service for the purposes of establishing whether the taxpayer has met the required minimum 91 days continuous service. In addition, other types of temporary absence will not break continuity of foreign service provided that the time away does not exceed one sixth of the total number of days of foreign service.

In summary, the requirement in most of the residency tests to determine an individual's residency status via his or her individual personal facts and circumstances is a major contributor to compliance costs for affected individuals.

5 Difficulty in administration

The fifth element for judging simplicity is to determine whether there are any administrative difficulties in applying the residency rules for individuals. If the rules are difficult to administer then the rules will fail this element of the simplicity criterion.

In many ways, this element is the mirror of the compliance costs for individuals (discussed above). However, the enactment in 1987 of s 23AG of the 1936 Act has the effect, from a practical viewpoint, of removing the need to resolve questions of cessation of residency for some foreign employed taxpayers, thereby reducing the Commissioner's workload.²¹⁴

However, as s 23AG of the 1936 Act does not resolve the residency issue, the principal factor that still influences administrative costs arising from the residency rules for individuals is that a person's residency depends upon their individual personal facts and circumstances. As a result it is impossible for the ATO to give simple broad binding pronouncements on how the law operates in respect of the majority of taxpayers,²¹⁵ as illustrated by Taxation Ruling IT 2650 (which is merely a guideline rather than a firm statement on the application of the law).²¹⁶ The result is the Commissioner must incur

214 The Commissioner has released only 3 rulings on the general operation of s 23AG - see Taxation Ruling TR 96/15, *Income Tax: Foreign Tax Credit System: Issues Relating to the Practical Application of s 23AG*, Class Ruling CR 2001/33, *Income Tax: Exempt Foreign Employment Income: Australian Federal Police Employees Stationed in the Solomon Islands as Members of the International Peace Monitoring Team* and Class Ruling CR 2004/109, *Income Tax: Exempt Foreign Employment Income: Section 23AG: Australian Federal Police Personnel on Long Term, Non-diplomatic Posting to East Timor (Timor-Leste) Under the Auspices of the Timor-Leste Police Development Program*. However, the one gap arises from the ATO's reluctance to publish a list of countries that do not tax employment income. Although it would have a monitoring cost it would mitigate against individuals (seeking employment in places where salary and wages are exempt or no income tax is levied) receiving erroneous advice.

215 ATO's first Internet Report, above n 183, 100. However, the ATO has posted on its website non-binding indicative commentary (and examples) on residency of individuals - see URL: <http://www.ato.gov.au/individuals/content.asp?doc=/content/12503.htm&pc=001/002/012/003&mn=1113&mfp=001/002&st=&cy=1> located on 7 June 2004.

216 See the Preamble in both IT 2650, above n 51, and to the former IT 2607, above n 16. However, TR 98/17, above n 16, is claimed to be an interpretative document rather than a document providing guidance.

the costs associated with responding to individual private rulings requests, which is a costly exercise (see discussion on ATOIDs above).

Finally, in order to overcome the inequity that can emerge in the application of the residency rules the Commissioner will often issue concessionary tax rulings in order to achieve the desired position.²¹⁷ Such administrative outcomes are achieved through reliance on the Commissioner's power of general administration of law, which embodies the good management rule.²¹⁸ This creates further administrative difficulties for the Commissioner who must balance the administrability of the law with the plain intent of the words of the legislation.²¹⁹

In summary, the requirement in most of the residency tests to determine an individual's residency status via his or her individual personal facts and circumstances remains a major contributor to tax administration difficulties for the Commissioner.

6 *Co-ordinated with other tax rules*

The sixth element for judging simplicity is to determine whether residency rules for individuals are co-ordinated with other tax rules. If the law operates independently of other tax rules, the rules will fail this element of simplicity. This will be explored at two levels, first in terms of related tax acts and then in terms of the OECD model Convention.

(a) *Other definitions in related tax acts*

Although the residency rules under the income tax law are consistent with those operating under the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (the

217 This is illustrated in residence by the fact that the former Taxation Ruling IT 2268, *Residency Status of Overseas Students Studying in Australia*, para 10, (which concessionally deems overseas students to be residents if their course of study extends beyond six months) was fundamentally inconsistent with the approach adopted in respect of other taxpayers in the former IT 2607, above n 16, paras 9, 11, 12. It has been recently argued that a differential treatment between new arrivals and foreign students still continues – see Australian Taxation Office, Commonwealth, Nation Tax Liaison Group (NTLG) Minutes for 26 March 2003, item 16, at URL: <http://www.ato.gov.au/taxprofessionals/content.asp?doc=/content/35852.htm&pc=001/005/036/001/002&mnu=&mfp=&st=&cy=1> located on 3 May 2004.

218 Taxation Administration Act 1953, s 3A.

219 For a discussion of the Commissioner's powers see Michael Carmody, 'The Art of tax administration: Two years on' (Paper presented at 6th International Conference on Tax

GST Act), as the GST Act has adopted the same “Australian resident” test contained in the 1936 Act,²²⁰ the rules are inconsistent with other residency provisions in related tax laws. For example under s 3(1) of the *Income Tax Rates Act 1986 (Cth)* there are seven residency definitions: “resident trust estate”, “resident beneficiary”, “resident taxpayer”,²²¹ “non-resident trust estate”, “non-resident beneficiary”, “non-resident taxpayer” and “prescribed non-resident”. Only the “resident trust estate” definition has any consistency with the 1936 Act.

As discussed above, the difference in the tests for residency adopted in the 1936 Act and in s 3(1) of the *Health Insurance Act 1973 (Cth)* result, in some limited circumstances, in a person being liable to pay the Medicare levy, but not being eligible for Medicare benefits. Other persons will have eligibility for Medicare benefits but no Medicare levy is payable. This arises as the *Health Insurance Act* residency definition is based upon an immigration basis, while the s 6(1) residency definitions, which are broader in scope, are based upon taxation concepts of residency.²²²

The Medicare levy inconsistencies are “. . . the direct and intended result in many cases of the different legislative policy adopted in each of the relevant Acts as to which persons should be treated as Australian residents”.²²³ The ATO concludes “[i]t is unlikely, in the view of this Office, that many cases will arise where the difference in the tests for residency in the two Acts produces what might be regarded as an inappropriate result that could not have been intended by the legislature.”²²⁴

Despite there being different policy reasons for the various definitions, the interrelationship of the various definitions should not result in inconsistent treatment of taxpayers in similar economic circumstances. This conflict can be avoided by the adoption of the similar definitions, or limiting Medicare levy liability to those entitled to receive medical benefits under the *Health Insurance Act*.

Administration, Sydney, 15 April 2004), 9-11, at URL: <http://www.ato.gov.au/corporate/content.asp?doc=/content/sp200401.htm> located on 3 May 2004.

220 The definition of “Australian resident” in s 995-1 of the 1997 Act is adopted in s 195-1 of the *New Tax System (Goods and Services Tax) Act 1999 (Cth)* (the GST Act).

221 The operation of this definition has been discussed above.

222 IT 2615, above n 95, para 17.

223 Ibid para 23.

(b) Divergence from the OECD model

The second area of divergence is the variations in the form of residency tests in each treaty (resulting in part from a failure to adopt the OECD model residency article). This idiosyncratic approach to wording in Australian DTAs can only lead to interpretative issues, particularly where there is wide divergence from the OECD Model Convention. Such variations also tend to slow the DTA negotiation/renegotiation process. As a result such arbitrary departures tend to counter the simplicity objective.

In summary, the domestic residency rules for individuals diverge from definitions in related tax acts and the DTA rules also diverge from the terms adopted in the OECD model. This divergence is a further erosion of simplicity.

7 Clarity

The final element for judging simplicity is to determine whether the law is expressed clearly. If the law is expressed unclearly, the law will fail this element of simplicity. A lack of clarity can arise in three situations.

First, a lack of clarity arises where a taxpayer is resident for only part of the year. Although it is clear under the “resides” or “domicile” tests²²⁵ that residency commences from date of arrival in Australia, it is not clear under the 183 day test. The older precedents indicate that a finding of residency under the 183 day test deems the person to have been resident for the whole year,²²⁶ while a more recent Board of Review case indicates that apportionment is possible.²²⁷

It is also argued that the pro-rating of the tax-free threshold may solve some problems.²²⁸ Despite the pro-rating of tax thresholds, the potential inclusion of otherwise

224 Ibid.

225 *Case 29* (1985) 28 CTBR (NS); *Case S19 85* ATC 225.

226 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774; 4 ATD 397; 1 AITR 201.

227 Hamilton, above n 40, para 2.150. However, the case cited in support may have limited precedence value as *Case 29* (1985) 28 CTBR (NS); *Case S19 85* ATC 225 concerned departure from Australia. The Board found the purpose of the 183 day test is to aid in determining residency and it plays no part in determining when someone departs Australia - see especially PM Roach at 248 and 232 respectively.

228 Hamilton, above n 40.

exempt offshore income derived prior to arrival in Australia remains an equity issue.²²⁹ Without a definite start date for residency, the 183 day test fails the clarity criterion.

Secondly, as discussed above, there is a lack of clarity in the definition of “Territory resident” in s 24C of the 1936 Act. A “Territory resident” is defined as a person, other than a company, who “resides” and has his or her “ordinary place of residence” in a prescribed territory. Given that residence is only one part of the test it is not clear to what extent the “resides” concept is qualified by the term “ordinary place of residence”. This uncertainty is due in part to the fact that what constitutes an “ordinary place of residence” is not defined.

The term “ordinary place of residence” may be equivalent to “ordinarily resident”. However, this is unlikely as usage of both terms is incompatible since the term “ordinarily residence” describes a lesser form of attachment to a country than “residence”. An alternative interpretation is that given that the Part is intended to only provide tax exemption for persons who genuinely live in the territory, the words “ordinary place of residency” may impose a physical residence requirement (ie require a place of residence (home or apartment) in the Territory).²³⁰ Although this later interpretation is supported by extrinsic material, the actual meaning remains unclear. Given this lack of clarity, the territory resident test fails the clarity element.

Finally, and most significantly, another area where clarity is lacking is that there is no express hierarchy between the four tests set out in s 6(1) of the 1936 Act (ie does the resides test have precedence over domicile test etc). Although illustrative of poor clarity in drafting, this is in practice a cosmetic concern. As mentioned early in this chapter, the courts tend to apply the relevant extension tests (ie either the domicile test, or the 183 day test or the Commonwealth superannuation test) in conjunction with the common

229 Another illustration of the law seeking to capture income derived whilst non-resident is in div 16E of the 1936 Act. Where a “qualifying security” (in terms of the definition in s 159GP(1)) is held by a person who is a non-resident for whole or part of the year s 159GW denies the operation of certain parts of div 16E. The effect of s 159GW(2)(c) is that “. . . in the year the payment is made, amounts that would otherwise have been assessable under section 159GQ in respect of the payment, but which are excluded by the operation of paragraph 159GW(1)(a), are to be brought to account as assessable income. This means that these accruals amounts are effectively taxed on a realisation basis” (see the Explanatory Memorandum, Taxation Laws Amendment Bill (No 2) 1986 (Cth), 76). The words of s 159GW(2)(c) clearly catch amounts that “would have been included in the assessable income of the taxpayer of any year or years of income under section 159GQ in respect of the payment in respect of the period of non-residence.”

230 Above n 91.

law resides test. In summary, both the 183 day and the Territory resident tests are expressed unclearly.

8 Summary

From the discussion above, the residency rules relating to individuals fail the elements that gauge simplicity. Specifically, as the outcome under the resides, domicile, 183 day, territory resident, ordinarily resident and some tiers of the DTA tie breaker tests can turn on a single fact (the facts and circumstances), the outcome in many circumstances is not predictable. Further the complexity arising from the facts and circumstances approach adopted in the resides, domicile, 183 day and territory resident tests is disproportional in general to the underlying policy, and is a major contributor to compliance costs for affected individuals and to tax administration difficulties for the Commissioner.

As well, the residency rules under s 6(1) of the 1936 Act, in conjunction with the rules under the *Income Tax Rates Act 1986 (Cth)*, deliver inconsistency in treatment between foreign diplomatic and consular staff and their families when compared to other foreign nations working in Australia. Finally, the domestic residency rules for individuals diverge from definitions in related tax acts and the DTA rules also diverge from the terms adopted in the OECD model and both the 183 day and the Territory resident tests are expressed unclearly.

In conclusion, most of the residency rules relating to individuals fail the elements that gauge simplicity (ie they are not predictable, not proportional, not consistent, are associated with the imposition of high compliance burdens, are difficult to administer, are not co-ordinated with other tax rules and are expressed unclearly).

D. Tax Avoidance

In determining compliance with the prevention of tax avoidance objective, the following discussion will identify three circumstances where in the application of the law there appears to be evasion or avoidance opportunities (ie under the 183 day test, the domicile test and generally in respect mobility of residence).

1 *Domicile test*

The first area of manipulation relates to the domicile test in s 6(1)(a)(i) of the 1936 Act. As discussed above, under the domicile test a finding that a person is domicile in Australia will not equate with residence where a person can prove that he or she has established a permanent place of abode elsewhere. However, the scope of this rebuttal has been expanded by the decision in *Applegate*, where Fisher J found that the phrase “permanent place of abode” was not intended to mean that the taxpayer needed to establish a permanent home, rather the taxpayer merely has to establish a home (ie “the taxpayer's fixed and habitual place of abode”).²³¹ As a result, the scope of the domicile test has been narrowed by this expansion.

Thus, an Australian domiciled taxpayer merely has to establish an abode in the foreign country (ie not being a temporary or transitory abode)²³² to avoid the domicile test. This ability to avoid the test could include the very taxpayer the domicile test was intended to capture, “. . . the High Commissioners for Australia and Agent-Generals for the Australian States together with members of their staffs . . .”.²³³ This avoidance occurs in at least two circumstances.

First, Article 14 of the Japan DTA could exclude the personal service income of such persons from income tax in Japan, provided they are not permanent Japanese residents. However, although these Articles reserve Australia's right to tax these government employees, it does not follow that the right to impose income tax actually exists under the 1997 Act due again to the scope of the “permanent place of abode” rebuttal.

Secondly, under Article 19 of the United States DTA, each country gives up the right to impose income tax on wages, paid to a citizen of the other contracting state, for personal services performed in their jurisdiction, provided the services performed relate to governmental functions. Thus, a state government employee posted to a foreign mission,

231 (1979) 9 ATR 899, 910-11; 79 ATC 4307, 4317. *Applegate*, a solicitor, was asked by his firm to go to the New Hebrides (now Vanuatu) to establish a branch office and manage it. *Applegate* gave up the lease on his flat and moved with his family. Although his stay was for an unspecified time, he was forced by illness to return within two years. He claimed his foreign source income was exempt because he was a non-resident for tax purposes. Although the Full Federal Court held that he had retained his Australian domicile, they found that he had established a permanent place of abode elsewhere.

232 Ibid.

233 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10.

or an Australian domiciled taxpayer locally engaged by an Australian mission, could be exempt from income tax on her or his personal service income derived in the United States.²³⁴ As the income is sourced where it is earned,²³⁵ and as non-residents they are only taxable under s 6-1 of the 1997 Act on income with an Australian source, they would also escape Australian tax. For the locally engaged staff that have severed ties with Australia for some time, the existence of a permanent abode in the foreign country would be relatively easy to establish.

Thus, diplomatic staff will have usually had a “fixed and habitual place of abode” in the place of posting, thereby having in terms of the dicta in *Applegate* a “permanent place of abode.”²³⁶ This is contrary to the stated purpose of the rebuttal ie to ensure that persons who had abandoned their Australian residence would not be caught.²³⁷ On the facts of *Applegate* complete abandonment to the extent intended had not occurred.²³⁸

Outside these extreme examples, other taxpayers are able to thwart the domicile test (as expanded by *Applegate*). Thus, the domicile test fails to meet its legislative intention of capturing government workers and also fails to satisfy the specific criterion of prevention of tax avoidance.

2 183 day test

The second area of manipulation occurs in respect of the 183 day test in s 6(1)(a)(ii) of the 1936 Act. The 183 day test, which is intended to capture persons who spend more than 183 days in the jurisdiction, in fact, often fails to capture such persons due to defects in the measurement rules.

234 Under the *Internal Revenue Code of 1986*, IRC § 893 such income is exempt provided the employee is not an US citizen, the services performed are of a character similar to those performed by US employees in the foreign country, that country must grant a similar exemption for US employees and that the government body is not a commercial entity. Also see ATO Interpretative Decision ATO ID 2002/283 (Withdrawn 14.9.04) *Income Tax: Assessability of Salary and Wages Earned by Locally Engaged Staff of any Australian Embassy in the United States – An Australian Resident*. Sweden, which also exempts income of non-nationals who are resident in Sweden and locally engaged employees with foreign embassies and consulates, is intending to tax this income from the assessment year 2008 – see Ed, ‘Proposal on taxation of employment income from foreign embassies and consulates in Sweden’ *IBFD Tax News Service - Headlines* (3 June 2004).

235 *Federal Commissioner of Taxation v French* (1957) 7 AITR 76, 86; 98 CLR 398, 415; 11 ATD 288, 296 (Williams J): “. . . the real source of the income in any practical sense must be the place where this personal exertion takes place.”

236 *Domicile Act 1982* (Cth) s 7.

237 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10.

238 A description of facts of *Applegate* is above n 56.

As mentioned previously (Part I, A, III (b)) the measurement for residency under the 183 day test is an income year (ie 1 July to 30 June). Thus, a taxpayer could spend up to 364 days in Australia without satisfying the 183 day test provided the 182 days were prior to 1 July and balance were from 1 July. This provides a major tax planning opportunity, particularly for expatriate experts employed in Australia in their first and last year of their assignment.²³⁹

Thus, the 183 day test fails to satisfy the specific criterion of prevention of tax avoidance as specific classes of persons can easily avoid the test.

3 Mobility of residence

The final area of manipulation relates to the mobility of residence. It is generally recognised that the residency rules are confined by jurisdictional boundaries. Combine these physical limitations with the sometimes facts and circumstances nature of the residency tests and the conditions have been created to enable manipulation of a person's residency status. Traditionally, high wealth taxpayers (successful musicians, sports persons and business people)²⁴⁰ take advantage of the individual, physically based, residency tests in order to select their desired residency (or non-resident) status.²⁴¹

They have been able to do this, by manipulating their circumstances to obtain residency in a lower taxed jurisdiction while, in many cases, retaining essential links with their country of origin.²⁴² For example, a person may seek to take advantage of a migration program to a country offering a better environment for their families (such as Australia), while at the same time avoiding the residency downside²⁴³ by keeping income earning assets outside Australia's tax net.²⁴⁴

239 Andersen, above n 20, 4.

240 A recent example of such a mobile individual was the late Sir James Goldsmith who was reported as flying to Spain to die to avoid high French death duties - see Fred Brenchley, 'Goldsmith avoids tax on death bed' *Australian Financial Review* (Sydney), 21 July 1997, 12. This phenomenon is not new. The 1920s have been called the golden age of residence litigation in the United Kingdom when the low taxed south of France was crowded with expatriate British living on their war loan interests - Sumpton, above n 40, 31.

241 This problem internationally has been accelerated by the removal of border controls. The 183 day test is reliant on tight border controls. Where there are no controls tax authorities have evidentiary difficulties in enforcing the 183 day test - see Brian Arnold and Michael McIntyre, *International Tax Primer* (1995), 21. This is not such a problem in Australia as Australia still maintains robust immigration/border controls.

242 OECD, *International Tax Avoidance and Evasion: Four Related Studies* (1987), 24.

243 The phenomenon of split households where children and a parent or grandparent live in one state while the parent is based in the state of origin, but regularly commutes to the émigré state is

Concerns about the malleability of the residency rules have been heightened by the developments in mass communications technology and the spread of the Internet. As the Internet has no jurisdictional boundaries²⁴⁵ it is argued²⁴⁶ that it is possible for some taxpayers to operate via the Internet in a particular country without actually being physically present in the country.²⁴⁷ The ATO in its 1997 report on taxation and the Internet found that the application of the existing jurisdictional rules is doubtful²⁴⁸ as the residency concept, which is based upon physical or territorial nexus with Australia, is likely to erode.²⁴⁹ The ATO believes that the effective application of the residency rules is in serious doubt; they were designed for an era in which electronic commerce did not exist.²⁵⁰

Similar concerns have been expressed by other commentators who argue that the future of both the 183 day test, and to a lesser extent the resides test, is questionable in light of

documented in L Pan (ed), *Chinese Overseas* (1999) cited in Nolan Sharkey, *An Examination of the Individual Residency Rules, Policy, Practical Operation and Foreign Comparisons* (MTax paper, University of New South Wales, ATAX, 1999), 3.

244 The Commissioner has attempted to limit the ability of migrants to obtain the Australian lifestyle for their families, while attempting to exclude their foreign income from Australia's tax net - IT 2681, above n 16.

245 ATO's first Internet Report, above n 183, 45.

246 Alan Tyree et al, *Computer Money Consulting Pty Ltd's INNET 97/2 Report on Electronic Commerce Banking and Finance Issues* (1997) Australian Taxation Office at URL: <http://www.ato.gov.au/content/Businesses/Downloads/cmc.rft>, Part 2 as at 31 December 2002. The report has subsequently been removed from ATO site. In Part 6 of the report the authors create Scenario 5S which illustrates this problem. It involves an Australian resident with an international reputation in environmental consulting establishing a Web Page located in the Bahamas, purchasing a yacht as his base of operations and the latest communications equipment so he can operate on the Web, run video conferences, and communicate anywhere in the world from his yacht. He conducts his contracts in Australia and elsewhere by sub-contracting physical analysis, preparing the report on the yacht and receiving payments via Internet money stored on his hard disk. He redirects some of that money to pay his subcontractor, and invests surplus money through offshore intermediaries. They conclude that the former resident seems to have abandoned his Australian residence and, without some legislative amendment, will not be taxed as an Australian resident. They further argue no country may have jurisdiction over his consultancy income if he consults from his yacht on the high seas. Other examples have been cited of telecommuting knowledge workers (lawyers and consultants) and physicians remotely diagnosing patients on the Internet (see Dale Pinto, 'The Nation State: Will it Survive Globalisation?' (2000) 3 *Journal of Australian Taxation* 136, 140 and 147) and executives (Gzell (1997), above n 11, 23).

247 The facts of a Canadian case, *R & L Food Distributors Ltd v Minister for National Revenue* [1977] CTC 2579; 77 DTC 411, illustrates this is a real life possibility. Here the shareholders of a company spent more than 183 working days in Canada during the year but returned to their permanent homes in the United States at night (except for only 6 to 7 nights during the year). The Tax Review Board found that this lifestyle did not amount to a presence (a sojourn) in Canada for a period of 183 days nor had they established temporary residence in Canada.

248 Finding 18, ATO's first Internet Report, above n 183, 100.

249 Pinto, above n 246, 148.

250 ATO's first Internet Report, above n 183, 35. At footnote 68, the report states that "[t]he US has already acknowledged this in adopting residence based taxation as a preferred base for taxation."

the development of electronic commerce given the reliance of the tests on geographic location.²⁵¹ The ATO, in its 1997 report on taxation and the Internet concludes that:

[t]he global nature of the Internet creates challenges for tax jurisdictions and the current . . . residency . . . rules [and i]t is likely that the existing international rules will need to be substantially revised in light of electronic commerce.²⁵²

A 1997 consultant's report, prepared for the ATO's Electronic Commerce Project also recommended radical reform.²⁵³

Despite these concerns the ATO is uncertain whether there has been an increase in funds mobility due to the development of the Internet.²⁵⁴ In fact, the ATO acknowledges that there “. . . is no immediate appreciable impact upon tax collections.”²⁵⁵

Further, although other commentators concede the existence of the traditional threat of highly trained professionals seeking low jurisdiction countries, they believe the threat should not be exaggerated as there is an open question whether the individual residency tests are “. . . more prone to manipulation in the digital age.”²⁵⁶ In fact tax is rarely the only or even the main reason for emigration²⁵⁷ as many people will choose to live in a higher tax rate country for lifestyle reasons.²⁵⁸ This is illustrated by the failure of the Singapore Government's tax incentives, introduced to lure back Singaporeans living abroad. Emigration is unlikely unless it offers an equivalent or better environment.²⁵⁹

251 It is argued that in the context of the internet the 183 day test is untenable - see Zak Muscovitch, 'Taxation of Internet Commerce' (1996) at URL: <http://www2.magma.com.com/%7Edbell/tax.htm> as at 24 April 1997. Also see similar concerns in Clinton Alley, Duncan Bentley and Simon James, 'In Need of Reform? A Trans-Tasman Perspective on the Definition of 'Residence'' (Paper presented at the 13th Annual Australasian Tax Teachers' Association Conference, Sydney, 3 February 2001) 10.

252 ATO's first Internet Report, above n 183, vii.

253 Tyree *et al*, above n 246, Part 2.

254 Bentley notes the ATO has concerns about business migration to low tax jurisdictions - Duncan Bentley, 'The ATO, Tax and the Internet: The Emperor's New Clothes?' (1999) 9 *Revenue Law Journal* 98, 119.

255 ATO's first Internet Report, above n 183, v. But they did believe that tax revenues are likely to be affected by the stages of development of electronic commerce.

256 Gitte Heji, 'The Internet Fails Tax Mesh' *Australian Financial Review* (Sydney), 22 July 1999.

257 *International Tax Avoidance and Evasion: Four Related Studies*, above n 136, 24.

258 Uta Kohl, 'The Horror-Scope for the Taxation Office: The Internet and its Impact on 'Residence'' (1998) 21 *University of New South Wales Law Journal* 436, 438.

259 *International Tax Avoidance and Evasion: Four Related Studies*, above n 136, 24.

Thus, the scenario of the yacht bound Internet consultant avoiding tax worldwide is a little far-fetched²⁶⁰ as “[w]hat these visionaries do not seem to understand is that most people would rather part with their tax than be permanently seasick.”²⁶¹ In fact Kohl argues that the domicile test in s 6(1) of the 1936 Act proposes a great hurdle to those who do not wish to absent themselves from Australia indefinitely,²⁶² as a taxpayer with an Australian domicile regains residency when they lose his or her overseas permanent place of abode.²⁶³

It follows that it is believed by some that the residency test is fairly immune from Internet manipulation as it relies on substantive rather than formal ties²⁶⁴ and in general it has been “. . . assumed that peoples' work is more immobile than their capital.”²⁶⁵

In conclusion, the residency rules have equal applicability to persons operating in both the electronic and physical markets. However, due to the development in electronic communication the residency rules continue to be subject to “. . . tax planning, particularly from defects such as over reliance on form and geographical location.” Further, “[t]he Internet provides ample opportunity for jurisdiction shopping in relation to the parking of important sources of wealth (and power) such as intellectual property in low tax jurisdictions.”²⁶⁶ Thus, the residency tests again fail to satisfy the specific criterion of prevention of tax avoidance as mobile residents, assisted by the growth of the Internet, can easily avoid the tests.²⁶⁷

260 Tyree *et al*, above n 246, Part 6 Scenario 5S.

261 Kohl, above n 258, 438. However, from 2002 people are in fact able to participate in a continuous circumnavigation of the world as part of “a luxury community at sea” if they purchase one of the 110 custom designed “residences” on a ship, named “the world” – see ‘Unending Rewards Aboard ‘The World’ [2001] 1 *Christie’s Great Estates* 20-1.

262 Kohl, above n 258, 439.

263 Alley (1995), above n 42, 52.

264 Kohl, above n 258, 440.

265 Marin Wolf, ‘Does Globalisation Render States Impotent?’ [2000] *British Tax Review* 537, 539.

266 ATO’s first Internet Report, above n 183, 100.

267 For completeness it is important to note that in respect of gains in respect of specific assets (ie those that have “necessary connection with Australia” as defined in s 136–25 of the 1997 Act), there are anti avoidance rules to stop avoidance of tax through changes in residency. Thus, Australia reserves the right to tax persons on capital gains either when they become non-resident or upon later disposal of assets “necessary connection with Australia” (see 1997 Act ss 104-160(3), 104-165(2) and 104-165(3)). However, these rules do not stop tax avoidance as both enforcement difficulties result in taxpayers ignoring the rules (see Sullivan, above n 354, 1707-8) and there are some impediments arising under DTAs (see Ian Gzell, ‘Treaty Protection from Capital Gains Tax’ (2000) 29 *Australian Tax Review* 25). A number of countries adopt a variety of trailing and exit tests to tax income/gains of departing residents – see *Cahiers de Droit Fiscal International: The Tax Treatment of Transfer of Residence by Individuals* Vol LXXXVIIb (2002).

4 Summary

From the discussion above, it is apparent that the resides, the 183 day and the domicile tests in s 6(1) of the 1936 Act fail to counter tax avoidance where it is carried out by persons who have mobile income sources.

E. Conclusion

In summary, from the above it is clear that the existing law for determining the residency of an individual is inadequate. Overall it fails in identified ways to satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criteria. Even the superannuation test, which is the one rule that is simple and is not manipulated, fails the horizontal equity requirement. The major weakness in the other residence tests for individuals (resides, domicile, 183 day, Territory resident and ordinarily resident tests and elements of the DTA tie breaker tests) is the “individual fact and circumstances” element of the tests, which in certain situations:

- results in horizontal inequity;
- gives rise to the lack of simplicity; and
- leaves the rules open to manipulation.

Further, as indicated above, although the facts and circumstances element of the tests does cater for an individual’s circumstances, individual facts and circumstances does not equate to horizontal equity.

Given that the rules fail all the criteria, there is no need to address any potential conflicts in the evaluative criteria. However, it is important to briefly note that although it is argued that qualifying a “facts and circumstances” test by objective criteria can provide the balance between simplicity and equity,²⁶⁸ this has not occurred in the Australian context. Instead, the “permanent” or “usual” place of abode qualifications to the domicile and the 183 day tests (respectively) and the intention (objectively) to take up residency qualification to the 183 day test provide opportunities for manipulation and do little for simplicity.

²⁶⁸ Arnold, above n 241, 22.

Thus, to ensure that the residency rules relating to individuals do better meet the evaluative criteria it is clear that the rules need to be reformed.²⁶⁹ The potential reform options are the focus of the following discussion.

IV. Exploring the Sub-Thesis - Models for reform

A. Overview

The sub-thesis is that the domestic law can be modified within the jurisdictional framework to more closely meet the evaluative criteria (ie alternative approaches to the current rules that may better satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance). In order to establish the sub-thesis a two-step approach will be adopted.

First, in Part IV a review of the residency rules adopted domestically in a number of jurisdictions will be undertaken in conjunction with a selective examination of specific residency tests against the evaluative criteria. As the Australian DTAs are based upon the OECD model convention, and the variations away from the OECD model are identified in the analysis of DTAs in Part II, the comparative study will not encompass DTAs.

The comparative review will be two staged. Initially, the review will look at the residency rules for individuals in the context of each country's tax system. The countries examined will be divided into common law countries that tax through a single code (Canada, New Zealand and the United States), common law countries that operate on a schedular system (Ireland and the United Kingdom) and the European civil law countries (France and Germany). The countries chosen are a representative sample from both common and civil law jurisdictions and include both countries with schedular tax legislation and countries with a single tax code. This approach allows for comparison of the various hierarchies of residency tests adopted in each country within the three jurisdictional types, which cannot be demonstrated by merely evaluating the broad categories of residency rules for individuals used world wide.

²⁶⁹ In fact as far back as 1975 the Asprey Committee (Asprey Report, above n 102, 260) found that there was "... a case for extending the exercise of jurisdiction to tax on the basis of residence so that all foreign income is subject to Australian tax and credit so far as administratively feasible."

The comparative studies of the domestic approaches adopted in foreign jurisdictions are completed by comparing and evaluating the individual residency test. As the tests can be classified into three broad categories, the tests will be evaluated under the following three categories:

- individual facts and circumstances;
- an arbitrary number of days; and
- specific criteria.

This process will assist in identifying alternative models and potential solutions to the problems encountered in Australia's domestic law.²⁷⁰ Thus, in Part V, in light of the comparative analysis, a number of reforms options (that are within the jurisdictional limitations) are reviewed against the evaluative criteria in order to determine whether the proposed rules are more equitable, efficient, simple and more able to prevent tax avoidance.

B. Comparing foreign residency rules in their domestic tax system context

As mentioned above, I intend to first review the residency rules for individuals in a number of jurisdictions in the context of each country's tax system. To facilitate this review, the countries examined have been divided into common law countries that tax through a single code, common law countries that operate on a schedular system and the European civil law countries.

1 Residency rules in common law countries taxing through a single code

The first part of the comparative review of residency rules in other jurisdiction focuses on three common law countries which, like Australia, principally have a single federal government income tax code: Canada, New Zealand and the United States.

²⁷⁰ As noted by Review of Business Taxation, Commonwealth, *An International Prospective: An Information Paper Commissioned from Arthur Andersen Examining How Other Countries Approach Business Taxation* (1998) iii and 3 a review of other jurisdictions will not give a blueprint for reform as they are often struggling with the same tax issues. However, it does give some guidance in developing the best approach tax problems.

(a) *Canada*

The terms “resident” and “ordinarily resident” are used in the Canadian *Income Tax Act* 1985.²⁷¹ However, despite the term resident being used more than 400 times in the *Income Tax Act*,²⁷² leaving aside deeming provisions, neither the term resident, nor the term ordinarily resident, are defined. Thus, the Canadian tax law relies principally on the common law to determine residency of individuals on the basis that they are “resident” or “ordinarily resident” in Canada.²⁷³ Although the outcome under common law is ultimately determined by an individual’s facts and circumstances, the Canada Customs and Revenue Agency in administering the law looks to four factors:

- the permanence and purpose of the stay abroad,
- residential ties with Canada,
- residential ties elsewhere, and
- the regularity and length of visits to Canada.²⁷⁴

Although the concepts “ordinarily resident” (ie a taxpayer has a settled routine of life, regularly, normally or customarily lives)²⁷⁵ and “resident” have a different meaning at common law, under the Canadian tax law a person who is ordinarily resident is deemed to be a resident.²⁷⁶

The *Income Tax Act* (Can)²⁷⁷ deems persons to be residents if they:

- “sojourn” in Canada for more than 183 days in a year;²⁷⁸

271 *Income Tax Act* RSC C 1985, 5th Supplement (as amended).

272 Edwin Kroft, ‘Jurisdiction to Tax: An Update’ (1993) *Canadian Tax Foundation Corporate Management Tax Conference papers* 1:6.

273 *Thomson v Minister of National Revenue* [1946] DTC 812.

274 Canada, Customs and Revenue Agency, *Determination of an Individual's Resident Status*, Interpretation Bulletin IT-221R3. See also Thomas Gillespie, ‘Relief for Employees Working Abroad: 1983 Federal Overseas Employment Tax Credit and 1983 Quebec Overseas Employment Deduction’ in Canadian Tax Foundation, *Report of Proceedings of the Thirty-Fifth Tax Conference* (1983) 443.

275 It covers former residents who have not severed all links with Canada see – *McFadyen v The Queen* [2000] DTC 2473. Also see Jack Bernstein and Kay Leung, ‘Who is Ordinarily Resident in Canada?’ (2001) 22 *Tax Notes International* 1309 and Jack Bernstein and Kay Leung, ‘News analysis: CCRA updates residency guidance’ (2002) 26 *Tax Notes International* 260.

276 *Income Tax Act* RSC C 1985, s 250(3).

277 The fundamental concepts underlying the rules can be traced back to 1927 – see Kroft, above n 272, 1:6. They were last modified in 1999 – see Bernstein (2001), above n 275.

278 *Income Tax Act* RSC C 1985, s 250(1)(a).

- are members of Canadian Forces²⁷⁹ or overseas Canadian Forces school staff²⁸⁰ or their dependent child;²⁸¹
- are an ambassador, high commissioner, minister, agent-general or other Canadian or provincial government official or their dependent child;²⁸²
- are participants in certain international aid projects or their dependent child;²⁸³ or
- are persons exempt under a DTA because they were related to, or a family member of, a Canadian resident individual.²⁸⁴

The 183 day test is not based upon mere presence, but rather a person “sojourning”. Unfortunately the terms “sojourn” and “day” are not defined.²⁸⁵ To compound the problem, the word “sojourn”, has an uncertain meaning and is not used in statutes in other countries.²⁸⁶

Finally, where a person fulfils the residency requirements under the *Income Tax Act* but is deemed under the tie breaker test in a DTA to be a resident in another state, the person is treated as non-resident for tax purposes.²⁸⁷

In summary, the rules for determining residency of an individual are principally based upon a facts and circumstances resides test, a 183 day test and objectives tests principally related to government service and exemption from foreign source income due to a DTA.

(b) *New Zealand*

New Zealand's residency test for individuals, which was revised in 1988, is found in s OE1 of the *Income Tax Act 1994* (NZ).²⁸⁸ The primary rule is a “facts and

279 Ibid s 250(1)(b).

280 Ibid s 250(1)(d.1).

281 Ibid s 250(1)(f).

282 Ibid s 250(1)(c) and (f).

283 Ibid s 250(1)(d) and (f).

284 Ibid s 250(1)(g).

285 See generally Gwyneth McGregor, ‘Deemed Residence’ (1974) 22 *Canadian Tax Journal* 381-90.

286 Ibid 384-5.

287 Ibid s 250(5).

288 Section OE1 is a restatement of the revised s 241(1)-(5) of the *Income Tax Act 1976* (NZ). Section OE 1 has been incorporated into the latest rewrite of the New Zealand tax law, the *Income Tax Act 2004* (NZ). The Act, which received Royal Assent on 7 May 2004, will come into force on 1 April 2005 and, unless the context requires otherwise, will apply to income derived in the 2005/06 and subsequent tax years.

circumstances” test, which determines residency if the individual has an enduring relationship with New Zealand.²⁸⁹ Under this test, a person is a resident if they have “a permanent place of abode” in New Zealand.²⁹⁰ The fact they have “a permanent place of abode” elsewhere is expressly ignored.

The second test is a 183 day test. Residency is deemed to arise where an individual is present in New Zealand for more than 183 days in any 12 month period.²⁹¹ Residence is deemed to have commenced from the first day within the 12 month period the individual was personally present in New Zealand. A day is defined to include part of a day.²⁹²

The third residency test determines when an individual is deemed to have lost (abandoned) residency (ie has become a non-resident). Non-residency occurs where the resident individual is absent for more than 325 days in any 12 month period.²⁹³ Non-residency is deemed to occur from the first day of absence.

However, there is a lack of linkage and a lack of clear hierarchy between the three tests. For example, there is uncertainty around the implicit linkage between the “permanent place of abode” and the “abandonment” test.²⁹⁴ There is also debate about whether the “183 day” test or the “abandonment” test has predominance.²⁹⁵ This is an issue where the 183 days straddle two income years (ie who is deemed to be a resident in the second year) and an individual is subsequently absent from New Zealand for more than 325 days in that second income year (ie is deemed to have lost residency in the same year).

Finally, there is a government service provision, which deems all government employees acting in any capacity for the government to be residents despite being absent for 325 days.²⁹⁶ The rule does not apply to persons employed in state owned enterprises.²⁹⁷

289 *Income Tax Act 1994* (NZ) s OE1(1).

290 These words have similar meaning to the Australian “permanent place of abode” test (discussed above at Part II A 3 (a) (ii)) - see Garth Harris, above n 110, 10-15, C J Mancer, *Staples' Guide to New Zealand Tax Practice* (54th ed, 1994) para 975 and Inland Revenue, New Zealand, *IR 292: New Zealand tax residence* (2001) see URL: <http://www.ird.gov.nz/library/publications/geninfo/ir292.pdf> located on 30 May 2004.

291 *Income Tax Act 1994* (NZ) s OE1(2).

292 *Ibid* s OE1(4).

293 *Ibid* s OE1(3).

294 The linkage between *Income Tax Act 1994* (NZ) s OE1(1) and s OE1(3) is not expressed but is implied - see Garth Harris, above n 110, 9. This view is consistent with the approach adopted in 1988 draft legislation - see New Zealand, Consultative Committee on International Tax Reform and Full Imputation, *Second Report* (July 1988) para 2.4.

295 See Garth Harris, above n 110, 9-10 and C J Mancer, above n 290, 808-9.

296 *Income Tax Act 1994* (NZ) s OE1(5).

Thus, the New Zealand approach is a residency test, which contains a balance of both “facts and circumstances” test (contained in the “place of permanent abode” test) with objective tests (183 day, government service and an abandonment tests).

(c) *United States*

The residency rules adopted under the *Internal Revenue Code of 1986* (US) seek to determine tax residency by two distinct, independent methods: by immigration status and by physical (substantial) presence.

First, the residency rules seek to align an individual’s immigration status with their tax status by the use of two immigration based tests of residency: the “citizen” test and the “green card” test. Thus, under the Code all citizens²⁹⁸ of the United States, wherever resident, are liable for income tax on their worldwide income (“citizen test”).²⁹⁹ Similarly, “resident aliens” are deemed to be residents and liable for taxes on a worldwide basis.³⁰⁰ A “resident alien” is an individual that has lawfully entered the United States as a permanent resident (“green card” test).

The second method of attachment is by “substantial presence” test. There are two tests. First, a taxpayer is deemed to be a resident if they are present in the United States for more than 183 days.³⁰¹

Second, a taxpayer is deemed to be resident if the taxpayer is present in the United States for more than a notional 183 days, calculated with reference to the days in the current year and the number of “deemed” days in the preceding two years. The individual must be present for a minimum 31 days during the calendar year for the test to apply.³⁰² The test does not use the actual days spent in prior years, but a discounted calculation whereby the days in the preceding year are counted as a third of a day while the days present in the second preceding year are counted as a sixth of a day. For

297 Garth Harris, above n 110, 16.

298 A citizen is a person born or naturalised in the United States - Reg 1.1-1(c).

299 *Internal Revenue Code of 1986*, IRC § 1. The income upon which the taxpayer is assessed is determined by § 61, taxable income by § 63.

300 *Internal Revenue Code of 1986*, IRC § 7701(b)(1)(A)(i). However, unlike the citizen test these rules do not apply to estate or gift taxes, which are determined upon concepts akin to domicile – see Joseph Isenbergh, *International Taxation* (2000), 19.

301 *Internal Revenue Code of 1986*, IRC § 7701(b).

302 *Ibid* § 7701(b)(3)(A)(i).

example, a person spending a 121 days in the United States each year, over a three year period, would not be resident under this “carry over days” test as the total number of days under the formula would be less than 183 day (ie 181.5 days).³⁰³

However, where individuals spend less than 183 days in the United States they may escape residency under the “carry over days” test if they can establish that their tax home is in a foreign country for the whole of the year and they have a closer connection to such foreign country than to the United States (the “closer connection” exception).³⁰⁴ The “tax home” is defined to be the place of the individual's place of business, or place of abode,³⁰⁵ while the place of “closer connection” is determined by a list of subjective and objective factors.³⁰⁶

The substantive presence test will not apply where the individual is an exempt individual, that is, they are:

- foreign government representatives and their families;³⁰⁷
- visiting teachers, trainees, and students;³⁰⁸
- professional athletes competing in charity sports events;³⁰⁹
- persons unable to leave the United states due to a medical condition;³¹⁰
- persons in transit between two foreign ports;³¹¹ or
- commuters residing in Mexico or Canada.³¹²

However, these exemptions only protect non-residents where the non-resident retains the status giving rise to the exemption. Thus, a graduate student who remains in the United States after graduation could be deemed a resident for the whole year if they remain in the country for more than 183 days after graduation.³¹³

303 121 current year days plus 40.3 first preceding year days (1/3 of 121) plus 20.17 second preceding year days (1/6 x 121) = 181.5 days – see Isenbergh (2003), above n 46, para P6.15.

304 *Internal Revenue Code of 1986*, IRC § 7701(b)(3)(B).

305 Ibid § 911(d)(3) (without regard to the second sentence thereof).

306 Ibid reg 301.7701(b)-2(d).

307 Ibid § 7701(b)(3) (D), 7701(b)(5)(B); Reg 1.7701(b) – 3(b)(2).

308 Ibid § 7701(b)(5)(C).

309 Ibid § 7701(b)(6)(A)(iv).

310 Ibid § 7701(b)(3)(D)(ii). However, this only extends to persons prevented from leaving the United states due to illness, not persons who enter the United States for treatment – see Isenbergh (2000), above n 300, 19.

311 *Internal Revenue Code of 1986*, IRC § 7701(b)(7)(C).

312 Ibid § 7701(b)(7)(B).

313 Isenbergh (2000), above n 300, 24.

Finally, a person can elect to be a United States resident in a calendar year, provided they meet the substantial presence test in the following year.³¹⁴

Thus, the main components of United States tests for determining an individual's residency are based upon determinative criteria. Only the "closer connection" exemption to the carry over days substantial presence test is based upon the individual facts and circumstances criterion.

(d) *Summary*

Despite similar tax code structures and being common law jurisdictions, the rules for determining residency vary between the jurisdictions from a system heavily weighted on individual facts and circumstances (Canada) to a system consisting of objective rules (the United States). What is common across these three common law jurisdictions is that all the countries use to varying degrees an individual's facts and circumstances in conjunction with objective tests.³¹⁵

2 Residency rules in common law countries that operate on a schedular system

The second stage of the comparative review of residency rules in other jurisdictions is to examine the rules operating in two common law countries which have a schedular income tax code: Ireland and the United Kingdom.

(a) *Ireland*

Under Irish tax law there are three key concepts used in determining residency for individuals: "resident", "ordinary resident" and "domicile".³¹⁶ A finding that an individual satisfies one, or a combination, of the "resident", "ordinary resident" or "domicile" tests will determine an individual's liability according to the test or combinations of the tests satisfied. Thus, an individual who is:

314 Ibid § 7701(b)(1).

315 Arnold, above n 241.

316 The tests for "resident" and "ordinary resident" individuals operate for the purposes of the *Tax Acts*, the *Capital Gains Tax Acts*, and the *Capital Acquisitions Tax Consolidation Act 2003* (IRE) - the *Taxes Consolidation Act 1997* (IRE), s 818. Also see Joe Martyn, Paul Reck, and Terry Cooney (ed), *Taxation Summary* (27th ed, 2003).

- “resident”, “ordinary resident” and “domiciled” is taxed on their world wide income;
- not resident, but is “ordinary resident” and “domiciled” will be taxed as a resident³¹⁷ but not in respect of foreign income derived from a profession or trade carried outside Ireland and other foreign income that is less than a prescribed amount;³¹⁸
- “resident”, but is not “ordinary resident” and not “domiciled” will be taxed on Irish and United Kingdom sourced income and remittances of foreign income;³¹⁹ and
- not “resident” and not “ordinary resident” is only taxable on income from the exercise of trade profession or employment in Ireland and all other Irish source income.

The principal residency test is a 183 day test. Thus, an individual is a “resident” for a year of assessment if the individual is present, at any one time or several times during the year for a period amounting to 183 days or more.

The test also deems an individual to be resident if the individual has a combined presence in Ireland of 280 days or more, taking into account the number of days on which the individual is present in the current year and the number of days on which the individual was present in the preceding year of assessment. However, it does not apply where a person was present in Ireland for less than 30 days in an income year.³²⁰ The impact of the extended 183 day test is that residence is established where average presence over two years is 140 days per year.³²¹

Also, an individual can elect to be treated as resident, provided the individual can satisfy an authorised officer that the individual has the intention to be a resident and that the individual will be resident in the State for the following year.³²²

317 *Taxes Consolidation Act 1997* (IRE), s 821 (ss 17, 18, and Ch 1 of Part3).

318 *Ibid*, s 821.

319 *Ibid*, s 71.

320 *Ibid*, s 819(1).

321 See generally Revenue Ireland, *Residence Manual: Legislative Notes on Sections 149-158 Finance Act 1994* (1996).

322 *Taxes Consolidation Act 1997* (IRE), s 819(3).

The concept of “ordinary residence” is also defined.³²³ An individual becomes ordinary resident if the individual has been resident in Ireland for each of the three preceding years³²⁴ and will cease to be ordinary resident only when the individual has not been resident in Ireland in the three preceding years.³²⁵

There are specific rules to deal with partial year residency (arrivals and departures)³²⁶ and rules that offer relief for residents who spend at least 90 days working outside Ireland and the United Kingdom.³²⁷

The final test is a “domicile” test. As mentioned previously, the domicile test is the common law concept, ie is a legal relationship between a person and a country by which the person is able to invoke the country's laws as their own.³²⁸ As this is similar to the Australian “domicile” test (discussed in Part II A 3(a)) I do not propose to repeat that examination.

Thus, in summary, the main components of Irish tests for determining an individual's attachment (“resident”, and “ordinary resident”) are established by the objective criterion of the number of days physically present in Ireland. Only the “domicile” criterion is based upon determination of an individual's facts and circumstances.

(b) *United Kingdom*

The concepts of “resident”, “ordinary (or ordinarily) resident” and “domicile” determine, to varying degrees, the incidence of tax for individuals under the United Kingdom's income tax,³²⁹ capital gains tax³³⁰ and inheritance tax.³³¹ Under the United Kingdom's

323 *Taxes Consolidation Act 1997 (IRE)* s 820.

324 *Taxes Consolidation Act 1997 (IRE)* s 820(1).

325 *Taxes Consolidation Act 1997 (IRE)* s 820(2).

326 *Taxes Consolidation Act 1997 (IRE)* s 822.

327 *Taxes Consolidation Act 1997 (IRE)* s 823.

328 *Henderson v Henderson* [1965] All ER 179.

329 Thus, under s 18(1)(a)(i) and (ii) of the *Income and Corporation Taxes Act 1988* (UK) (ICTA), s 820 D taxes resident persons on gains accruing from property and possessions (Cases IV and V) or trade, profession, or vocation carried on, no matter where derived (Cases I and II). Where the person is a non-resident Commonwealth citizen, they are taxed on income from a trade, profession, or vocation carried on in the United Kingdom (s 18(1)(a)(iii)).

330 Capital gains tax is payable on a gain on the disposal of the asset by a person who is resident or ordinarily resident (ss 1 and 2 of the *Taxation of Chargeable Gains Act 1992* (UK) (TCGA)), regardless of the jurisdictional location of asset. Under s 12 of the TCGA the gain on an asset located outside the United Kingdom will be exempt where the resident or ordinary resident individual is not domiciled in the United Kingdom. Where taxpayer is neither resident nor ordinary

schedular tax system (which categorises income into schedules according to characterisation and source)³³² each specific residency definition determines the quantum of assessable income under each schedule.

The principal determinative of residency is the “resides” test, which is a common law facts and circumstances test.³³³ Common law residency is determined by reference to factors such as physical presence in United Kingdom, residence in previous years, regularity of visits to the United Kingdom, the purpose of those visits and whether a place of abode is located in the United Kingdom.³³⁴

However, for income tax, the “resides” test is supplemented by three statutory rules that deal with Commonwealth and Republic of Ireland citizens temporary abroad, residents abroad, and temporary residents in the United Kingdom. These statutory rules are found principally in *Income and Corporation Taxes Act 1988 (UK)* (ICTA). The tests include concepts of “ordinary resident” and “domicile”, which are again common law based.

The principal statutory test, found in s 336 of the ICTA, is a negative phrased variation of a 183 day test. Thus, s 336 provides that individuals who are in the United Kingdom temporarily, who do not intend to reside in the United Kingdom and have not actually resided for a whole six months, will not be taxed:

- on income chargeable under Schedule D in respect of possessions and securities earned outside the United Kingdom;³³⁵

resident, but carries on a trade in the United Kingdom, gains on the disposal of assets situated in the United Kingdom are taxable (TCGA s 10).

331 Domicile is the key concept under the *Inheritance Tax Act 1984* (UK) (IHTA). All transfers of property, wherever situated, during the last seven years of their life and on their death will be subjected to tax under s 1 of the IHTA. Only transfers of property located in United Kingdom are taxable for persons domiciled outside the United Kingdom (IHTA s 6(1)).

332 The schedular system has existed since 1803 - Davies, above n 45, 16.

333 United Kingdom Codification Committee, above n 78, 35 noted in 1936 that the probable explanation for the absence of specific residency definitions “. . . is that the original Acts were drawn at a time when, as compared with the present conditions, transport facilities were rudimentary and the mobility of the population almost negligible.”

334 Whiteman, above n 200, 114, Sumpton, above n 40, 15 and Abimbola Olowofoyeku, ‘Where is my home? Reflections on the law of residence’ [2003] *British Tax Review* 306.

335 Section 336(1) and (1A). Section 336(1) first appeared as s 8 of the *Income Tax Act 1799* (UK) - Davies, above n 45, 85.

- from the 2003-04 tax year, on certain pension and social security income and foreign benefits chargeable under Parts 10 and 11 of *Income Tax (Earnings and Pensions) Act 2003* (UK); and³³⁶
- for years prior to 2003-04 tax year, emolument income charged under Cases I to III of Schedule E.³³⁷

If the individuals stay for six months they become liable for tax on that income.³³⁸ The six month period is calculated in calendar months.³³⁹ A finding of residency, where an individual has exceeded the six months, will result in a tax liability to United Kingdom tax for the whole of the tax year of arrival unless an exemption is issued by the Commissioners of National Revenue for the period up to the date of arrival.³⁴⁰

Further, under the common law the availability of living accommodation for temporary residents deems the person to be resident and ordinary resident (the so called “place of abode” test).³⁴¹ The Inland Revenue states that the “place of abode” test will be satisfied if upon arrival an individual owns accommodation in the United Kingdom, buys accommodation during the tax year, enters into a lease of three or greater years duration or the accommodation is acquired or leased in a subsequent year.³⁴²

However, the test has been overridden by statute in two distinct situations. The availability of living accommodation in the United Kingdom will not determine purpose

336 Section 336(1A). Parts 10 and 11 of the *Income Tax (Earnings and Pensions) Act 2003* (UK) (ITEPA) were inserted following the repeal of Schedule E, s 19(1)(1) of the ICTA by ss 722 to 724 of the ITEPA for the 2003-04 tax year and subsequent tax years.

337 Section 336(2). Section 336(2) originates in the *Finance Act 1956* (UK) - Davies, above n 45, 85.

338 Students who are in the United Kingdom for the purpose of education, will be treated by the Inland Revenue as not being “ordinary resident” provided they are in the United Kingdom for less than four years, they do not buy accommodation, enter a three year lease, or plan to return regularly after completion of study - Inland Revenue, United Kingdom, *IR 20 Residents and Non-residents: Liability to Tax in the United Kingdom* (1999) at URL: <http://www.inlandrevenue.gov.uk/pdfs/ir20.htm>, para 3.13 located on 12 December 2003.

339 *Wilkie v Inland Revenue Commissioners* [1952] 1 All ER 92; (1951) 32 TC 495, 508. Despite this decision the Inland Revenue since 1972 has calculated the period using 183 days (IR 20, above n 336). Davies (above n 45, 87-90) notes that although this methodology works to the advantage of taxpayers it is suspect to challenge. The Inland Revenue ignores the day of arrival and departure in the calculation - IR 20, above n 339, para 1.2.

340 Extra-statutory concession 11A - IR 20, above n 338, para 1.5. However, overseas income is taxable on the accrual or remittance basis for the period from the day of arrival to 5 April next. Income arising in the Republic of Ireland is liable on the accrual basis even though the recipient may be not domiciled or not “ordinary resident” in the UK - IR 20, above n 338, Ch 5.

341 *Cooper v Cadwalader* (1904) 5 TC 101 and *Attorney-General v Coote* (1817) 4 Price 183; abstract published in (1887) 2 TC 385.

342 IR 20, above n 338, para 3.11.

or intent under s 336 nor will it determine residence where the individuals perform their work either entirely or principally offshore (s 335).³⁴³

The Inland Revenue will also administratively claim residence and ordinary residence in respect of an individual where an individual satisfies the habitual visits test.³⁴⁴ Under the habitual visits test if individuals visit the United Kingdom on an average of 91 days or more over a four year period, they will be deemed to be resident in the fifth year.³⁴⁵

The term “ordinary residence” is used in s 334 of ICTA.³⁴⁶ Section 334 seeks to tax individuals (Commonwealth and Republic of Ireland citizens) that are “ordinarily resident” as if they were resident, where they have left the United Kingdom for the purposes of occasional residence abroad. As discussed earlier, in the context of Australia’s resides test, the words “ordinary resident” are defined by the common law as connoting “. . . residence in a place with a degree of continuity and apart from accidental or temporary absences.”³⁴⁷

Although the “domicile” concept has a key role in the *Inheritance Tax Act 1984 (UK) (IHTA)*, it also is important under the income tax law. Under the ICTA persons, who are not domiciled in the United Kingdom and, if a Commonwealth citizen or Irish citizen, not ordinarily resident in the United Kingdom, will only be taxable on remittances of foreign source income taxable under Schedule D Cases IV and V.³⁴⁸

The “domicile” concept is similar to that inherited in Australia and derives from the common law. However, the test is a rule of limitation (ie it limits liability), rather than a rule that attracts full world wide taxation (ie a general attachment rule) as in Australia. There is no single United Kingdom domicile; rather an individual is domiciled in one of the kingdoms of England, Scotland and Northern Ireland. As in Australia, the domicile concept in England, Scotland and Northern Ireland was modified by the *Domicile and*

343 Sections 335(2) (incidental work exclusion to the “place of abode test”) and 336(3) (exclusion) were only introduced in 1993 via *Finance Act 1993 (UK)* s 208.

344 IR 20, above n 338, paras 2.8-2.10, 3.3 and 3.5.

345 This test appears to have been derived from the decision in *Kinloch v Inland Revenue Commissioners* (1929) 14 TC 736.

346 Section 334 has remained substantially in its current wording since the *Income Tax Act 1918 (UK)*, but can trace its origins back to s 39 of the *Income Tax Act 1842 (UK)* - Davies, above n 45, 97-9.

347 *Levene v Inland Revenue Commissioners* (1928) 13 TC 486, 507 (Viscount Cave LC).

348 ICTA, s 65(4). The former ITCA, s 192(2) also turned on the domicile concept, excluding foreign emoluments of persons not domiciled in the United Kingdom from charge under Schedule E.

Matrimonial Proceedings Act 1973 (UK) to ensure that a husband's domicile no longer determines a wife's domicile.

In summary, the United Kingdom's rules are predominantly reliant on the determination of the facts and circumstances of the individual. As a result, a non-binding booklet issued by Inland Revenue (*IR 20 Residents and non-residents: Liability to tax in the United Kingdom*)³⁴⁹ is used by revenue authorities as a code of practice³⁵⁰ and is cited by most authors as illustrative of the law's operation.³⁵¹

(c) Summary

Despite similar schedular tax code structures and being common law jurisdictions, the rules for determining residency vary between a system heavily weighted on individual facts and circumstances (United Kingdom) to a system consisting of objective rules (Ireland).

3 Residency rules in civil law jurisdictions

The third stage of the comparative review of residency rules in other jurisdictions is to examine the rules operating in two civil law countries: France and Germany.

(a) France

France has principally adopted a facts and circumstances approach to determining “domicile” (residency) of an individual. Under the *Code General des Impots (FRA)*³⁵² individuals are “domiciled” (resident) in France if:

- their home (“foyer”) is in France (ie the place where the person lives, the “centre of family interest”, the usual place of abode);³⁵³

349 IR 20, above n 338, Preface.

350 Davies, above n 45, 22.

351 Ibid and Whiteman, above n 200.

352 *Code General des Impots (FRA)*, Art 4B. The civil law concept of domicile differs from the common law concept. It means the “place of factual residence with an intention of underdetermined duration”, ie the place which constitutes a permanent residency for most of the time - see Walter Ryser, ‘Switzerland’, in Timothy J Lyons, Huub Bierlaagh and Ramon J Jeffery (eds), *IBFD: The International Guide to the Taxation of Trusts* (4 December 2002), Switzerland 16.

353 Francis Lefebvre, *France: Business Law, Taxation, Social Law* (1992, updated 1994), 234.

- their principal abode (“lieu du sejour”) is in France. If a person resides in France for more than six months, they are usually deemed to have their principal abode in France;³⁵⁴
- they carry out a professional activity (including employment) in France, unless the professional activity is incidental;
- France is the centre of their economic affairs; or
- they are civil servants exercising their duties in other countries.

Although there is no express priority in the test, the Supreme Court in the *Larcher* case indicates that the home test was determinative, with the main abode test only being resorted to when the home cannot be determined with certainty.³⁵⁵

Thus, the French residency rules for individuals are principally based upon an individual’s facts and circumstances, with the only objective element of the French test being the government service rule that deems individuals engaged in government service offshore to be residents.

(b) *Germany*

The German definition of a resident individual is two tiered. First, an individual is defined to be a resident of Germany if they are “domiciled” (*Wohnsitz*) in Germany. “Domicile” is defined to be a home or dwelling maintained by the individual in the long term.³⁵⁶

Second an individual is resident if their “customary place of abode” (*gewöhnlicher Aufenthalt*) is within the domestic territory of Germany.³⁵⁷ An individual is deemed to have a “customary place of abode” if the duration of their domestic stay exceeds six months over two years.³⁵⁸

354 Inst, 26 July 1977; 5 B-24-77, No 4: D Admin. 5B-1121, No 6, 15 March 1993 - see Philippe Juilhard, ‘Towards a New Definition of Tax Residence in France - A Critical Analysis of the Larcher Case’ (1996) 50 *Bulletin for International Fiscal Documentation* 141.

355 Conseil d’Etat, 3 November 1995, no. 126513, *Larcher* cited in Juilhard, *ibid* and Louan Verdoner, ‘Major economic concepts in tax treaty policy’ (2003) 31 *Intertax* 147, 150.

356 German Fiscal Code (*Abgabenordnung* (“AO”)) § 8. Domicile is determined by external and recognisable facts rather than the intent of the individual. Thus, the legal right to occupancy may be sufficient to create domicile even if an individual resides abroad (eg a person who leases an apartment in Germany but is temporarily abroad) - see Ryser, above n 352.

357 German Income Tax Law (*Einkommensteuergesetz*) s 1 § 1.

358 *Abgabenordnung* § 9 AO.

Thus, the German two tiered test has both an objective 183 day test and a fact and circumstances “home” test.³⁵⁹

(c) *Summary*

The civil law jurisdictions examined display a similar variation in residency rules as operate in both the common law single code and schedular tax codes systems. Again the rules for determining residency vary between a system heavily weighted on individual facts and circumstances (France) to a system consisting principally of objective rules (Germany).

4 Traits emerging from comparative study

The above examination confirms that whether a jurisdiction adopts a facts and circumstance criterion or a more objective criteria in determining residency does not have any relevance to the basis of the legal system (civil or common law) nor to the structure of the tax codes (single code or schedular code). Nations set their residency rules based upon each jurisdiction’s own economic and social value judgments. Therefore, any examination of these foreign domestic residency rules against the evaluative criteria is best done on a rule-by-rule basis.

C. Comparing specific residency rules applicable in other jurisdictions

What can be drawn from the above contextual examination of the residency rules for individuals in other jurisdictions is that there are three broad categories of residency tests. Thus, connection to a jurisdiction is found through tests based upon:

- individual facts and circumstances tests (such as domicile, resides, home (permanent/habitual), ordinarily resident, centre of family or economic interests, and place of abode tests);
- an arbitrary number of days (so called 183 day test); and

³⁵⁹ A similar two tier test is adopted in Czech Republic, Hungary, and Luxembourg – see United Kingdom, HM Treasury and Inland Revenue *Reviewing the Residence and Domicile Rules as they Affect the Taxation of Individuals: A Background Paper* (2003), 12-22.

- specific criteria (citizenship, immigration status, and engagement in government service or other related activity).³⁶⁰

Given that all tests fall within these three categories, the three categories will be the basis for the following evaluation of the residency rules adopted in other jurisdictions. However, given a number of the foreign residency tests that have been adopted in Australia, and that I have already extensively evaluated the Australian rules, I will not be evaluating all the foreign residency tests identified against the evaluative criteria. Such an examination would merely duplicate this earlier analysis.

Therefore, the testing of specific residency tests adopted in other jurisdictions against the evaluative criteria will be limited to more unique foreign tests that have not been the subject of, or subsumed in, the previous analysis of Australia's rules. However, observation will be made where the form of the common residency rule adopted in another jurisdiction overcomes some of the weaknesses identified in respect of the Australian rule.

1 *Fact and circumstances tests*

As there has already been an extensive review of fact and circumstance tests in the Australian context, the following seeks to merely give an overview of the range of fact and circumstance tests adopted in other jurisdictions before briefly reviewing the tests in light of the evaluative criteria.

(a) *Overview*

There is a variety of fact and circumstances tests used to determine residency. The United Kingdom and Australia have a number of fact and circumstances residency tests

360 Richard Vann, 'International aspects of income tax' in Victor Thuronyi (ed) *Tax Law Design and Drafting* (Vol 2, 1998) 718, 719 suggests a general legal concepts (domicile and citizenship) category rather than the specific criteria category adopted above. Also see Alley, Clinton, Bentley, Duncan, and James, Simon, 'The New Zealand definition of 'residence' for individuals: Lessons for Australia in a 'global' environment' (2001) 4 *Journal of Australian Taxation* 40, 43.

Australia's residency rules for individuals also fit with the three categories, that is:

- the resides, domicile, ordinarily resident, and Territory resident tests, the usual and permanent place of abode glosses and elements of the tie breaker tests in the DTA's are in the individual facts and circumstances category;
- the 183-day test is in the arbitrary number of days category; and
- the superannuation test is in the specific criteria category.

in common, being the resides, domicile and ordinarily resident tests. The civil law concept domicile is used in Hungary, Saudia Arabia and Korea,³⁶¹ while Australia and Canada also share a common resides test. Other fact and circumstances tests are expressed in terms similar to the tie breaker test in the OECD model. These tests can be classified as follows:

- availability of a family/permanent home test (Austria, Netherlands, Czech Republic, France, Finland and Belgium);
- the centre of social and economic interest test (Austria) and place from which he manages his fortune, business or carries out his occupation (France, Netherlands and Belgium); or
- permanent or habitual abode tests (Hungary, New Zealand and United Kingdom).

Thus, the foreign fact and circumstances tests offer a diverse range of possible test criteria in order to determine whether an individual has, through their personal circumstances, established sufficient connection with a country. Their commonality lies in the fact that they require case by case application.

As the problems associated with the common law domicile and ordinary resident tests have already been reviewed in the context of Australia's residency rules (see generally Part III) and the scope of the centre of social and economic interests (ie centre of vital interests) tests were examined in the context of the OECD Model Convention (Part II C (b)(ii)), it is not proposed to repeat this discussion. Similarly, given that the scope of the availability of permanent home and the habitual abode tests were examined in the context of the OECD Model Convention (Part II C (b)(i) and (ii)) and residency and permanent place of abode tests have been evaluated in the context of Australia's residency rules (Part III), it is not intended to repeat this analysis in detail.

361 As mentioned (Ryser, above n 352) the civil law concept of domicile (which is the "place of factual residence with an intention of underdetermined duration") differs from the common law concept. The concept is used in the definition of residency in Saudi Arabia's new Income Tax Law (issued by way of Royal Decree M1 of 15/01/1425 AH (6 March 2004) and published in Official Gazette No. 3990 of 11/3/1425 AH on 30 April 2004) and executive regulations (issued on 15 August 2004 by the Department of Zakat and Income Tax). Thus, an individual is a resident if they have a (permanent) domicile in Saudi Arabia and whose stay in Saudi Arabia has been at least 30 days in a tax year – see Ed, 'Saudi Arabia: Executive regulations regarding new Income Tax Law issued' *IBFD Tax News Service - Headlines* (25 August 2004).

However, given that different residency, place of abode and dwelling tests have been given common labels, it is important to highlight variations in structure in order to identify reform models. Therefore, the following discussion will focus on aspects of the residency test and permanent abode/home/dwelling tests, before briefly revisiting the evaluation of the facts and circumstance model.

(i) *Resides test*

A number of jurisdictions use a residency based test. However, despite the similarity in labelled tests in Australia, Ireland and the United Kingdom, some of the tests are in fact not fact and circumstances tests. For example the concept of “ordinarily” resident in Ireland is based upon a prescribed presence in Ireland over three preceding years (an arbitrary day test), while the United Kingdom and Australian concept of “ordinarily” resident embodies residency with a degree of continuity determined in light of the individual’s facts and circumstances.

(ii) *Abode/home/dwelling tests*

In a number of jurisdictions the ownership or availability of place of abode (a home) (eg Austria and Netherlands) is one of the tests for determining residency. Determination of the existence of a home is generally a question of fact (ie a fact and circumstance test).

The threshold level of when use of accommodation will be considered to be a home varies from country to country ranging from the availability of temporary accommodation³⁶² to a permanent home (eg Belgium and France).³⁶³ Where the test requires availability of a permanent home the test usually adopts the wording of the OECD tie-breaker test. As the scope of this test has been discussed in the context of Australia’s DTAs, (see Part II C 2 (b)(i)), I do not propose to repeat that discussion.

362 In the United Kingdom a person who lived for a few weeks, from time to time in a house he owned in London was found to be resident see *Attorney-General v Coote* (1817) 4 Price 183; abstract published in (1887) 2 TC 385.

363 Edwin R A Seligman, *Essays in Taxation* (3rd ed, 1900), 109 notes that existence of permanent residence (or domicile) is a defensible basis in determining sufficient connection to tax, while mere temporary residence is inadmissible as a test as the relationship between the individual and the government is too slight.

However, in other countries the mere ownership of a home is sufficient to deem residency. For example, in the United Kingdom, the common law deems persons to be resident and ordinary resident if they have living accommodation in the United Kingdom (“place of abode” test).³⁶⁴ The United Kingdom’s Inland Revenue states that the “place of abode” test will be satisfied if upon arrival an individual owns accommodation in the United Kingdom, buys accommodation during the tax year, enters into a lease of three or greater years duration or the accommodation is acquired or leased in a subsequent year.³⁶⁵

Similarly, in Mexico the home does not need to be an individual’s principal or permanent abode and there is no minimum period of “ownership”. However, unlike the United Kingdom, the home test is the principal test of residency in Mexico.³⁶⁶

In summary, the home test is used in a limited number of countries as a domestic test to determine residency. It is more commonly used as a residency tie breaker test by countries using the OECD model treaty.

(b) *Evaluation*

Although it is claimed that the fact and circumstances tests are more “. . . compatible with the political theory that government power comes from the consent of the governed,”³⁶⁷ they do not satisfy the evaluative criteria. First, as discussed in the context of the Australian tests (see Part III A 1) the horizontal equity criterion is not met under facts and circumstance tests as minor variations in a taxpayer’s circumstances may result in taxpayers in similar circumstances being taxed differently.

Second, as discussed in the context of evaluating the Australian tests (see Part III C), fact and circumstance tests will generally fail the simplicity criterion. The case by case determinations of all key concepts means the rules can give rise to arbitrary outcomes,

364 *Cooper v Cadwalader* (1904) 5 TC 101 and *Attorney-General v Coote* (1817) 4 Price 183; abstract published in (1887) 2 TC 385.

365 IR 20, above n 338, para 3.11.

366 Terri Grosselin and Koen van’t Hek, ‘Latin America tax scene’ (2001) 29 *Intertax* 312, 314 and ‘Mexico – Tax residency definition change’ *Ernst & Young Human Capital HR & Tax Alerts* (January 2004). An individual who does not maintain home in Mexico will be considered a resident if they have vital interest in Mexico (ie if more than 50% of income comes from Mexico or Mexico is the principal site of the individual’s professional interests).

367 Michael McIntyre, *The International Income Tax Rules of the United States* (2nd ed, 1992) 1-21.

impose high compliance costs, create uncertainty and are hard to administer.³⁶⁸ Finally, as the tests rely upon individual facts and circumstances they are easy to manipulate (see Part III D 3) and they generally fail the tax avoidance criterion.

Thus, the foreign facts and circumstance tests, other than offering a range of possible test criteria, provide little guidance for reform as they too do not satisfy the evaluative criteria. Where the tests have been modified to alter the criterion from fact and circumstances to tests based upon a specific fact (eg home ownership) or a period of time (eg Irish ordinarily resident test), the outcome is similar as the tests fail different criteria (ie they fail to meet the horizontal equity and tax avoidance criteria, but will generally satisfy the simplicity requirement).

2 Arbitrary (183) day tests

As there has already been an extensive review of Australia's 183 day test (see Part III), the following seeks to provide an overview of the range of arbitrary day tests adopted in other jurisdictions before briefly reviewing the tests in light of the evaluative criteria.

(a) Overview

The most common determinative criterion, adopted in a vast majority of countries, is a substantive presence test gauged through presence in a jurisdiction for a prescribed number of days (usually 183 days). The so-called 183 day tests adopted in the various jurisdictions can be classified into a number of different time periods in which presence ("sojourn") will be sufficient to amount to residency. Thus, a person is deemed to be resident if they are present for a:

- 183 days (six) months in total, or consecutively, in the country (for example, Austria, Denmark, Germany, Iceland and Turkey);
- total of 183 days (or six months) in a tax year/calendar year (for example, Canada, Czech Republic, France, Greece, Hungary, Iceland, Ireland, Poland, Portugal, Slovak Republic, Saudi Arabia,³⁶⁹ Spain and United States);

368 Whiteman, above n 200, 137.

369 Above n 361.

- total of 183 days (or six months) in any 12 month period (for example, Finland, Luxembourg, New Zealand, Norway and Sweden);
- year continuously (for example, Korea).³⁷⁰

Thus, as well as the number of days varying between countries, the period over which the actual presence must occur varies between countries (ie between six and 12 months) as does the requirement of whether the number of days must be consecutive. Even what constitutes a day also varies between countries. For example, in New Zealand a day is defined to include part of a day,³⁷¹ while the day of arrival and the day of departure are not used in calculating presence under the United Kingdom's residency test.³⁷²

Further, unlike Australia, in order to minimise avoidance by persons leaving the country before the specified time period is satisfied, and returning once the period restarts a number of countries (Norway,³⁷³ the United States³⁷⁴ and Ireland³⁷⁵) have adopted tests that seek to take into account presence in prior years.

In summary, although the existence of a "183 day test" style test in most jurisdictions initially conjures assumptions of uniformity, the actual criteria used to establish the prescribed physical presence varies across the various jurisdictions.

(b) *Evaluation*

In evaluating the Australian 183 day test it was found that the test failed to satisfy the equity and tax avoidance criteria (see Part III A and D), while the facts and circumstance elements of the Australian test failed the simplicity criterion (see Part III C). Although it is likely similar criticism will apply to the arbitrary tests adopted in a number of

370 UK, Inland Revenue *Reviewing the Residence and Domicile Rules*, above n 359, schedule 3.

371 See above n 292.

372 See above n 339.

373 A taxpayer who has stayed in Norway (using the "day of physical presence" test contained in Art 15(2) of 2003 OECD Model Convention) for at least 183 days in a 12 month period is a resident. If spread over two years, then residency occurs in the year in which 183 days requirement is satisfied. Residency is deemed to occur where the individual's total presence in the country is 270 days in a three year period (ie an average of 90 days per year). Loss of residency only occurs if residency is established in another state and the person does not have a permanent home and has spent less than 61 days is spent in Norway - Fredrick Zimmer, 'Norway adopts new tax residency rules' (2003) 31 *Tax Notes International* 95.

374 See above n 302 and 303.

375 See above n 321.

jurisdictions, the sheer diversity in how the test is applied necessitates some further analysis.

First, the arbitrary day test lacks horizontal equity, as persons engaged in cross-border activities are also likely to be deemed a resident of more than one country³⁷⁶ resulting in taxpayers being liable for tax in two jurisdiction on the same income (ie taxpayers in similar circumstances are taxed differently). They often only catch taxpayers who are unsophisticated, unadvised,³⁷⁷ unlucky (an individual taxpayer being deemed a resident due to a tail wind causing the taxpayer to arrive half an hour earlier)³⁷⁸ or poor planners (where the taxpayer did not take into account that time period covered a leap year).³⁷⁹

The stricter the test, the more likely that double taxation will occur. Thus, the more the measurement of a 183 day presence in a country is done over a longer period (eg any 12 months in New Zealand) and the more countries deem residency based upon patterns of presence (eg taking into account presence in prior years) the greater the number of individuals that will be dual residents.

This double tax problem can be moderated by the use of DTAs, tax credits and fact and circumstance exemptions (eg the United States “closer connection exemption”³⁸⁰ and Australia’s permanent place of abode elsewhere exemption (see Part II A 3 (b))). However, the use of fact and circumstance exemptions can compromise simplicity, and DTAs offer only a partial solution as DTAs do not exist between all countries.³⁸¹

Second, generally 183 day tests will fail to satisfy the anti-avoidance criterion. Such test can be easy to avoid by remaining out of the country for the required number of days, or breaking the continuity of presence by leaving the country for a short period of time. Although these weaknesses can be overcome by measuring the required presence over a longer period or by including in the calculation presence in prior periods, this can impact

376 Arnold, above n 241.

377 Arnold, above n 241.

378 Alley (1995), above n 42, 52 cites as an example the case of an unlucky taxpayer (an university lecturer) who arrived on day 365 of his absence due to a tail wind, thereby retaining his residence in New Zealand. Unfortunately the judgment in *Case F138* (1984) 6 NZTC 60,237; *TRA Case 21* (1984) 8 TRNZ 140 does not record this fact.

379 Similarly in *Wilkie v Inland Revenue Commissioners* [1952] 1 All ER 92; (1951) 32 TC 495 a taxpayer was found not to be resident for more than six months in a leap year (365 days) as he had been present for only 182 days and 20 hours.

380 For example see the United States’ “closer connection exception”, above n 304.

upon horizontal equity. Further, enforcement of the “number of days” test is also difficult, as the period of residency may be difficult to establish where border checks have been removed or where a regional citizenship (such as a potential EU citizenship) replaces or overlaps member state citizenship.³⁸²

In summary, the more expansive 183 day tests adopted in New Zealand, Ireland and the United States are models that overcome the Australian test’s failure of the tax avoidance criterion. However, they achieve this through reducing horizontal equity.

3 Specific criteria tests

The following seeks to merely give an overview of the range of specific criteria tests before summarising the common failures in light of the evaluative criteria. As the specific criteria tests can be broken into two categories (government service and immigration based tests) the following examination will follow that categorisation.

(a) Government Service tests

The following analysis seeks to provide an overview of the government service tests adopted in other jurisdictions before briefly reviewing the tests in light of the evaluative criteria.

(i) Overview

Many countries adopted specific government service residency tests. Such tests are driven by the desire of nations to ensure that those persons serving those nations remain residents regardless of their period of absence from their home state.

As discussed above, Canada deems members of Canadian Forces,³⁸³ overseas Canadian Forces school staff,³⁸⁴ ambassador, high commissioner, minister, agent-general or other

381 For example, see the facts of *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 82; 78 ATC 4486 above n 17.

382 Sheridan, above n 47.

383 *Income Tax Act* RSC C 1985 (Can), s 250(1)(b).

384 *Ibid* s 250(1)(d.1).

Canadian or provincial government officials,³⁸⁵ and the dependent child of such persons³⁸⁶ to be residents.

Similarly, the New Zealand and French approach is to deem all government employees (civil servants) acting in any capacity for the government (exercising their duties) to be residents.³⁸⁷ While the New Zealand rule does not apply to persons employed in state owned enterprises,³⁸⁸ a similar rule in Korea deems directors and personnel engaged in overseas service on behalf of an employer who is a Korean resident or Korean domestic company to be resident.³⁸⁹

Other nations rely on the citizen or domicile tests to deem residency coupled with the Government service Article in DTAs (such as Article 27 of the OECD model), which ensures that the taxing rights of Government employees lies with the state for which they work.

(ii) Evaluation

Leaving aside the political/national imperative, government service tests are difficult to justify in terms of the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance.

Although government service tests create horizontal equity between all government workers (ie government workers in similar economic circumstances are treated similarly) they perpetuate horizontal inequity between those workers and all other non-resident workers employed by the non-government sector. However, the government service tests do generally satisfy the simplicity criterion as the rules apply in a predictable way, are not complex, result in low compliance costs, and are expressed clearly. The government service tests also meets the “co-ordinated with other tax rules” element of the simplicity criterion, as they are consistent with the government service rules in most DTAs.

385 Ibid s 250(1)(c).

386 Ibid s 250(1)(f).

387 *Income Tax Act 1994* (NZ) s OE1(5) and *Code General des Impôts* (FRA), Art 4B, respectively.

388 Garth Harris, above n 110, 16.

389 Korea, Ministry of Finance and Economy, *Korean Taxation* (2002), 29.

On balance, the rules may be justifiable upon Government policy reasons; however they cannot be justified under the evaluative criteria.

(b) *Immigration tests*

There are two main immigration based residency tests, the citizenship test and the lawful non-citizen residency test (ie “green card” test in the United States). The following analysis seeks to provide an overview of the immigration tests adopted in other jurisdictions before briefly reviewing the tests in light of the evaluative criteria. This analysis will be undertaken by first giving an overview of the citizenship test. The citizenship test overview will be followed by an overview of the lawful non-resident test before both tests are evaluated against the evaluative criteria.

(i) *Citizenship - overview*

Citizenship is one of the traditional ways that sufficient connection can be established. In fact, political allegiance (ie citizenship) of the taxpayer is the oldest principle of attachment.³⁹⁰ Despite it being the oldest form of attachment, it also is only adopted in a few nations (such as the Argentina,³⁹¹ Bulgaria, Japan, Philippines,³⁹² and the United States³⁹³). The United States, however, is the only industrialised country to tax the worldwide income of its non resident citizens.³⁹⁴ Although not a test of attraction, the concept of citizenship is also used in Australia in s 23AA of the 1936 Act (to ensure that an income exemption does not apply to Australian citizens) and in Article 1(I)(ii) of the 2003 United Kingdom Treaty (to define nationality).

390 Seligman (1900), above n 362, 109.

391 Argentina only adopted a citizenship test, qualified by an existing residency requirement, in 1998 - see Alejandro Messineo, ‘Tax Reform under way’ (1998) 32 *Tax News Service* 181. In contrast, Mexico moved away from a citizenship model in 1968.

392 The Philippines have had a citizenship model since 1918 - see Richard Pomp, ‘The Experience of the Philippines in Taxing its Nonresident Citizens’ in Jagdish Bhagwati and John Wilson (eds), *Income Taxation and International Mobility* (1989) 45.

393 The citizen test was adopted in the United States in 1913 - Jagdish Bhagwati and John Wilson, ‘Income Taxation in the Presence of International Personal Mobility: An Overview’ in Bhagwati, *ibid*, 27 and Sidney Ratner, *Taxation and Democracy in America* (1967) 333.

394 United States, Staff of the Joint Committee on Taxation, *Background Materials on Business Tax Issues* (2002), 54 at <http://www.haise.gov/jct/x-23-02.pdf> accessed on 30 January 2004. Also Seligman (1900), above n 362, 108.

Unlike the lawful non-citizen residency test, there is a strong political theory underlying the concept of citizenship and why citizens living abroad continue to have a tax liability. As citizenship is founded in political rights, it involves political duties.³⁹⁵

Broadly, as citizenship offers privileges (such as the right to vote, a right to protection and a right to return) it should entail obligations (in respect of military service and fiscal responsibility).³⁹⁶ As the right to vote means that the individual can influence how revenue is raised and spent, it is seen as inequitable and unreasonable to have the obligations lapse while still enjoying the rights.³⁹⁷ Thus, citizens living abroad (continue to receive legal and technical business infrastructure, military protection, passport and embassy services) have responsibility to their country.³⁹⁸

Citizenship based taxation is also seen as important for developing countries. Where a skilled individual emigrates the developing country loses the person's skills (which arise from a large education investment by the state), the potential future taxes and the ability to recoup the education investment in the individual.³⁹⁹

Despite these arguments, this approach is not universally accepted. In 1900 Seligman questioned the validity of arguments underlying a citizenship test. He stated that:

[i]n the modern age of the international migration of persons as well as capital, political allegiance no longer forms an adequate test of individual fiscal obligation. It is fast breaking down in practice, and it is clearly insufficient in theory.⁴⁰⁰

Further, Canada's Royal Commission on Taxation (the Carter Commission) recommended ". . . that residence continue to be the principal basis for determining liability to tax, largely because residence seems to imply a closer association than citizenship between the taxpayer and the use of services provided by a taxing jurisdiction."⁴⁰¹

395 Seligman (1900), *ibid*.

396 Richard Musgrave, 'Foreword' in Bhagwati, above n 392, xii and Kohl, above n 258, 441.

397 Seligman (1900), above n 362, 108.

398 US Joint Committee on Taxation, above n 392, 54 and Seligman (1900), above n 362, 108.

399 Musgrave, above n 396.

400 However, Seligman (1900) (above n 362, 109) argues that persons who are permanently resident in a place ought to contribute to that nation's expenses.

401 Canada, *Report of the Royal Commission on Taxation* (1966) Vol 4, 541.

(ii) Lawful non-resident - overview

The second immigration test is the lawful non-citizen residency test, which deems tax residency for alien persons given the right to reside in a state for a fixed or indefinite period. Unlike the citizenship test it is a creature of modern immigration rules and is not expressly supported by the rights and obligation arguments advanced for citizenship.⁴⁰² The lawful non-citizen residency test is only adopted as a tax residency test in a few nations, including Japan and the United States. However, only the United States seeks to tax these persons on their worldwide income, no matter where they reside.

(iii) Evaluating the immigration tests

Regardless of the rights and obligation argument underlying the immigration tests, it is important to determine whether the tests satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance.

First, the use of the immigration tests to determine residency and a world wide tax liability results in a lack of horizontal equity (ie taxpayers in similar economic circumstances are not treated similarly) with taxpayers with little connection to a jurisdiction being caught, while those with much closer ties, escaping liability.⁴⁰³ For example, a non citizen may be able to reside in the country for a number of days each year (eg up to 120 days per annum in the United States) and not be caught within the tests, while a citizen living offshore is potentially liable on their world wide income.⁴⁰⁴ Horizontal equity can be improved if their country of citizenship excludes tax of foreign source income earned by non-resident citizens.

Also, horizontal inequity arises through double taxation of dual resident non-resident citizens. Dual residency occurs where the country of residency also seeks to tax those non-resident citizens as residents. Double taxation will occur for the dual resident in the

402 Seligman (1900), above n 362, 109.

403 Although the US Joint Committee on Taxation (above n 398, 54) argues that world wide taxation gives rise to horizontal equity, the Committee did not analyse whether the rule of attachment (the citizenship test) gives rise to horizontal equity.

404 Kohl, above n 258, 449 notes that citizenship does not fully recognise the equitable notion that those who pay the taxes should actually have the ability to indirectly or directly benefit from them. A citizen who is liable for the tax may never set foot in a country and never use the roads. They may never enjoy the community services as in many instances citizenship will not give automatic rights to pensions, social security, health services and even some tax concessions.

absence of double tax relief under DTAs and if country of citizenship does not fully credit or exclude income taxed in country of residence.

The citizen and lawful non-citizen residency tests generally satisfy the simplicity criterion because the rules apply in a predictable way, they are not complex, result in low compliance costs, are expressed clearly and co-ordinate with the immigration rules.

Finally, the rules fail to satisfy the prevention of tax avoidance criterion. The immigration tests do not stop mobility as they are easily avoided by rescinding citizenship.⁴⁰⁵ Further, it is very difficult to enforce non-resident citizen compliance with the former country's tax laws.⁴⁰⁶ For example, it is claimed that only 10 percent of US nationals residing abroad long-term meet their tax return filing obligations.⁴⁰⁷ This problem is compounded by the absence of an international tax authority or administrative cooperation from the country of residence⁴⁰⁸ Thus, the immigration tests fail to satisfy the prevention of tax avoidance criterion.

In summary, although such tests are extremely simple, the simplicity is gained at the expense of equity.⁴⁰⁹ Further, without specific rules to deal with citizens leaving the jurisdictions for tax purposes⁴¹⁰ and the ability to enforce filing obligations on absentee citizens, the rules fail to prevent tax avoidance.

405 In fact the solution has been to enact specific legislation to countering renouncement of citizenship for tax purposes. Thus, s 877(a) of the *Internal Revenue Code of 1986* (US) removes for 10 years any advantages arising from non-residency from taxpayers who seek to avoid tax by relinquishing United States' citizenship or resident aliens (who have been residents for three consecutive years). Further, in March 1996 amendments to the immigration law (*Immigration and Nationality Act* (US)) were passed that have the effect of prohibiting the issue of a visa to a former United States' citizen, where the former citizen has renounced her or his citizenship to avoid United States' tax. These rules have resulted in 107 persons (from a population of over 258 million) being listed between 1997 and 1999 - see Martin Sullivan, 'Democrats Revisit Expatriate Tax: With Neutrality and Justice for all?' (1999) 19 *Tax Notes International* 1705. Also see Alice Abreu, 'The Difference between Expatriates and Mrs Gregory - Citizenship can Matter' [1995] *Tax Notes International* 1613, Charles M Bruce, 'Permanent Tax Exile - The plight of former US citizens?' (1996) 50 *Bulletin for International Fiscal Documentation* 205, Sanford Goldberg et al, 'Taxation Caused by or after a Change in Residence (Part 1)' (2000) 21 *Tax Notes International* 643, and Sanford Goldberg et al, 'Taxation Caused by or after a Change in Residence (Part II)' (2000) 21 *Tax Notes International* 741.

406 P Webster, *A Treatise on the Law of Citizenship in the United States* (1891) cited in Bhagwati, above n 392, 28 and Pomp, above n 392, 47.

407 Musgrave, above n 396, xiii. See also Sheridan, above n 47, 22.

408 *Re Visser* [1928] Ch 877 and *Government of India, Ministry of Finance (Revenue Division) v Taylor* [1955] AC 491. See also Musgrave, above n 396, and Pomp, above n 392, 47. Co-operation has been achieved in Australia in some limited cases through bi-lateral negotiation (eg *Foreign Judgments Act 1991* (Cth), which provides for reciprocal enforcement of specific tax debt judgments of Papua New Guinea and New Zealand, and Art 25(2) of the United States' DTA).

409 Kohl, above n 258, 440. Kohl argues that the nexus between residency and tax should be the equitable notion and that will not be achieved by the adoption a citizenship test.

410 Special rules that retain taxing rights despite absence from the jurisdiction are more commonly used, as citizenship alone does not stop evasion of jurisdiction. There are three approaches

4 Summary

Having evaluated the various tests within the three categories of residency tests for individuals that operate in other jurisdictions (ie the individual facts and circumstances tests, the arbitrary number of days tests and the specific criteria tests), what emerges is that those rules, like the rules operating in Australia, are unable to satisfy all the evaluative criteria. This occurs despite similarly named tests being structured differently from jurisdiction to jurisdiction. For example, the availability of a home test can be a fact and circumstance based test in some jurisdictions, while being a specific factor test in others.

D. Conclusions

In the above Part (Part IV), a comparative review of the residency rules adopted domestically in a number of jurisdictions was undertaken in two stages. Initially, the review looked at the residency rules for individuals in the context of each country's tax system. The countries examined were divided into common law countries that tax through a single code, common law countries that operate on a schedular system and the European civil law countries.

This initial review was intended to provide a comparison of the various hierarchies of residency tests adopted in each country within the three jurisdictional types, which could not be demonstrated by merely evaluating the broad categories of residency rules for individuals used world wide. In doing so, the review confirmed that whether a jurisdiction adopts a facts and circumstance criterion or a more objective criterion to determine residency is not the result of the legal system (civil or common law) nor of the structure of the tax codes (single code or schedular code). Nations set their residency rules based upon their own economic and social value judgments.

The second stage of the comparative review was to examine the foreign domestic residency rules against the evaluative criteria on a rule-by-rule basis. This was done by comparing and evaluating the individual residency test within the three broad approaches adopted world wide (individual fact and circumstances tests, arbitrary

adopted: to ignore the change; to tax but defer taxation until realisation (trailing approach); or to treat the act of expatriation as a taxable event deeming realisation of all gains.

number of days tests, and specific criteria tests) to determining connection to a jurisdiction.

What emerges from this second stage of the comparative review is that the residency rules adopted world wide, like the rules operating in Australia, are unable to satisfy all the evaluative criteria. Another outcome was that, despite a number of the categorised tests having similar names, often the tests were structured differently from jurisdiction to jurisdiction. These structural differences may offer ideas, if applied in Australia that may result in rules that better satisfy the evaluative criteria. The exploration and evaluation of the possible reform options will be the focus for the balance of the chapter (ie Part V).

V. Exploring the Sub-Thesis - Reform options

A. Overview

In Part III of the thesis it was established that Australia's current rules for determining the residency of an individual failed to satisfy the evaluative criteria of equity, simplicity and the prevention tax avoidance. In order to explore the sub thesis, that the law can be modified within the jurisdictional framework to more closely meet the evaluative criteria, a review of residency models adopted in other jurisdictions was conducted in Part IV. Although it was established that no individual country's model or particular residency test satisfied all the evaluative criteria, the process did reveal a number of refinements which, with further analysis, may provide the basis for modification of Australia's domestic law so that it more closely meets the evaluative criteria. Thus, the purpose of this Part is to explore the approaches for modifying the existing rules such that they better meet the evaluative criteria.

As discussed in Chapter 2 (Part V), given that the policy objectives do conflict, any modification to existing laws could favour one policy objective over another. Therefore, as stated in Chapter 2, where the tax policy objectives are in conflict the principal focus will be on ensuring equity. However, where the equity objective leads to a negative outcome in terms of simplicity (complexity) and tax avoidance, the reform option that provides a balance between the equity tax policy objective and the simplicity and anti-avoidance tax policy objectives should prevail.

Therefore, the approach adopted for reform involves changing some of the existing tests from the “fact and circumstance” model to the “arbitrary number of days” or specific criteria models (ie trading-off equity for simplicity and the prevention of tax avoidance). This is because as “[a]ny greater certainty by means of statutory rules can be achieved only at the expense of being arbitrary.”⁴¹¹ Such an approach, in a self assessment environment, carries with it the advantages of reducing the compliance costs due to reducing complexity and providing greater certainty for the majority of taxpayers. Provided these gains in simplicity outweigh any potential loss of horizontal equity arising from double taxation, then the result is a more balanced approach for determining residency of individuals.

B. Reform options

Having clarified the evaluative methodology, the next step is to consider each of the residency rules and determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. The process will consider the various reform options in respect of each of the residency rules before settling on the preferred reform options (see Part VI)

1 183 day test

There are two elements to the 183 day test in s 6(1)(a)(ii). The first element is that residency is deemed if a person is present in Australia for a total of more than 183 days in an income year. The second element is a fact and circumstance exemption that allows persons to escape the deeming test if they establish both that they have a usual place of abode outside Australia and do not intend to take up residency. In order to explore the possible options for reforming, the two elements of the 183 day test are examined separately below, before setting out the recommendations for reform.

(a) Deeming test

The 183 day test fails the tax avoidance criterion (see Part III D 2). This failure is due in part to the measurement period being the year of income. Therefore, persons who are in Australia for period up to 364 days could avoid the 183 day test if only 182 days is spent

411 Carter Commission, above n 401.

in each income year. This problem is common with many of the 183 tests used in other jurisdictions (see Part IV C 2) which contain similar limitations on their scope (ie they require continuous presence or use calendar year or income (fiscal) years as the measurement period).

However, a number of the tests used in other jurisdictions⁴¹² counter this problem (ie of persons avoiding the test by spending periods in excess of 183 days in two income years) by measuring presence over *any* 12 month period. Although this approach reduces tax avoidance it does have a wider impact upon horizontal equity as more taxpayers may be caught that are also resident elsewhere. However, the potential for double taxation is abated by both the “usual place of abode” and “intention to reside” glosses and the DTA tie-breaker tests. Therefore, the change in jurisdictional claim is relatively minor and the overall thrust and nature of the test remains.

The scope of the test could be further expanded if the prior year presence tests (similar to the United Kingdom and United States tests) were adopted. These are very wide tests as they take into account periods of less than 183 days in a number of prior tax years (see Part IV B 1(c) and 2 (b)). However, this change would be a major extension to intended jurisdictional claim, which is currently based upon annual measurement.

(b) Fact and circumstance exemption

The “usual place of abode” and the “intention” glosses to the Australian 183 day test were enacted at a time when Australia had no DTAs, to ensure horizontal equity by ensuring that there was “. . . no danger of treating as residents persons who are purely visitors.”⁴¹³ However, the “individual fact and circumstances” element of the tests result in horizontal inequity, give rise to a lack of simplicity and leave the 183 day rule open to manipulation (see Part IV).

Given these problems the temptation is to recommend removal of the “intention” and “place of abode” glosses to the 183 day test in order to increase simplicity and counter

412 These tests are used in countries such as Finland, Ireland, Luxembourg, New Zealand, Norway and Sweden. Norway has changed its 183 day test from continual presence to a cumulative presence of 183 days in any 12 month period – see Zimmer, above n 373.

413 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 11.

avoidance. However, this would have the effect of increasing horizontal inequity for persons engaged in cross border activities, usually those taxpayers who are unsophisticated, unadvised, unlucky or poor planners (see Part IV C 2(b)). In fact, it is argued that the criteria for establishing residence (such as the 183 day test) should be less rigorous than the abandonment test, due to the increased risk to horizontal equity for those engaged in cross border activities.⁴¹⁴

The double tax problem can be moderated through the use of DTAs and tax credits. However, this is only a partial solution as DTAs do not exist with all countries and tax credits are not always available in the other country of residence.⁴¹⁵ As a result many countries use fact and circumstance exemptions.⁴¹⁶

(c) Finding the balance

Although increasing simplicity can result in a decrease in horizontal equity through potential double taxation, the use of DTAs can moderate or remove the potential inequity. Given that Australia has treaties with all countries that are and have been a major source of Australia's migrant populations (except for Greece and Lebanon), and taking into account Australia escalating its treaty negotiation program, in the foreseeable future the DTA tie breaker rules should be open to the majority of persons caught in double tax situations.⁴¹⁷

An alternative to the new DTA program that would also reduce horizontal inequity would be the enactment of a series of exemptions specific for classes of persons (students,

414 Arnold, above n 241, 22. Arnold and McIntyre in their theoretical model (which has its origins in the United States citizen model and the OECD Model Convention tie breaker tests) use a two part formulation. First, if the individuals are present in a country for 183 days or more in a taxable year they are residents for that year unless they establish that they do not have a dwelling in the country and are not citizens of the country. Second, if they have a dwelling in the country they are residents unless they also have a dwelling in another country.

415 See, eg Richard Vann, 'Improving Policy for the Taxation of Expatriate Employees in Australia' (2001) 7 *New Zealand Journal of Taxation Law and Policy* 70, 73-4.

416 For example, the United States uses a "closer connection exemption" (see above n 304), while other jurisdictions use the OECD Model Convention tie breaker tests (ie having a dwelling/family/permanent home elsewhere or your centre of social and economic (vital) interest test elsewhere).

417 Treasurer 'Review of International Taxation Arrangements' (Press Release No 32, 13 May 2003), Attachment E.

visiting teachers or persons on specific classes of tourist visas⁴¹⁸), similar to the tests used in the United States (see Part IV 1(c)). As these exemptions rely on specific criteria, they are generally extremely simple. However, horizontal inequity would remain between persons within the specific exemptions and those persons not covered by a DTA that fall outside the exemption. Despite the merits of this approach, governments are often reluctant to pursue such approaches as such rules give away taxing rights, without similar concessions being granted to Australians.

In light of the above discussion and the need to counter avoidance and the resultant simplicity it is recommended that the 183 day test be revised to change the measurement period to any 12 month period, rather than a tax year. The suggested extension to the test to take account of prior year presence cannot be supported in the context of the sub-thesis, as it is a large extension of the jurisdictional claim.

Further, to increase simplicity, the “usual place of abode” and the “intention” glosses to the Australian 183 day test should be repealed. Given that the glosses were introduced to stop double taxation, and that role is now covered by DTAs, the practical effect of the any increase in jurisdictional claim would only be limited to that class of persons not covered by a DTA. The impact of this minor increase in jurisdiction could be further reduced by targeted exemptions for specific categories of non-DTA persons who would have had concessional treatment had a DTA been in place (eg students and visiting teachers).

However, the removal of the glosses would be a major variation to the structure of the 183 day test as the tie breaker tests contained in DTAs are different from the “usual place of abode” and “intention to reside” glosses. Although the practical outcome may be similar, the change does amount to a change in the domestic jurisdictional claim and as a result, this change cannot be recommended in the context of the sub-thesis.

Despite the retention of the glosses, the change in measurement period will result in a test which is simple, less easy to manipulate, does not create major horizontal inequities and will have the effect of ensuring that the domestic law of individual residency, within

418 Arnold and McIntyre in their theoretical model suggest that individuals who have either resident or non-resident status for visa or immigration purposes might be presumed to have the same status for income tax purposes – see Arnold, above n 241, 22.

the jurisdictional framework, more closely meets the “essential objectives” of equity, efficiency, simplicity and the prevention of tax avoidance.

Further, two technical amendments could also add further simplification. First, the law should be amended to clarify how the period is calculated by defining what time period constitutes a day (ie whether part of a day constitutes a day).⁴¹⁹ Also, as it is not clear under the 183 day test that residency commences from date of arrival in Australia (see Part III C 7), the law also needs to be amended to clarify this point.

Despite that only limited change to the 183 day rule is possible within the jurisdictional claim, these minor changes will ensure that the 183 day test more closely meets the tax policy objective of simplicity.

2 Domicile test

The domicile test under s 6(1)(a)(i) of the 1936 Act is a cessation test that determines when residency ceases. Thus, persons who are domiciled in Australia will remain resident until they establish a permanent place of abode elsewhere.

As both the “domicile” element and the “permanent place of abode” gloss are fact and circumstances tests, these rules fail a number of the elements that gauge simplicity (ie they are not predictable, not proportional and not consistent, are associated with the imposition of high compliance burdens, and are difficult to administer) (see Part III). The domicile test also fails to meet its legislative intention of capturing government workers (due to the Federal Court’s interpretation of “permanent place of abode” in *Applegate*⁴²⁰) and also fails to satisfy the specific criterion of prevention of tax avoidance.

In order to address these concerns, the options for reforming the domicile test are examined below, before setting out the recommendations for reform.

419 Section 36 of the *Acts Interpretation Act 1901* (Cth), which defines dates, is silent on what constitutes a day.

420 *Applegate v Federal Commissioner of Taxation* (1979) 9 ATR 899; 79 ATC 4307.

(a) *Evaluating options for reform*

Despite claims that the domicile test poses a great hurdle to those who do not wish to absent themselves from Australia indefinitely⁴²¹ (because a taxpayer with an Australian domicile regains residency when they lose his or her permanent place of abode⁴²²) and that it is a “better” test than citizenship (as a person has only one domicile at one time)⁴²³ there is broad support for the repeal of the domicile test.⁴²⁴

The residency cessation tests, adopted in other jurisdictions, range from fact and circumstances tests (such as the establishment of a dwelling in another jurisdiction) to specific time limit tests (see Part IV C). In some jurisdictions both style of tests are used.⁴²⁵

The dwelling test is more commonly used as a residency tie breaker test by countries using the OECD Model Convention (see Part IV C 3(a)). The dwelling test suffers from the difficulties of all fact and circumstances tests in respect of simplicity, equity and the prevention of tax avoidance.

As evidenced by the many and varied time limits used in the time-based tests used in other jurisdictions, it is clear that there is no preferred time limit. The choice of the appropriate time limit is arbitrary and dependent upon government policy. For example, the United States has adopted a statutory 10 year rule,⁴²⁶ while in the recent past a “two year” administrative rule had been adopted both in Australia⁴²⁷ and Canada.⁴²⁸

Arnold and McIntyre in their theoretical residency model suggest a further variation, ie “[i]ndividuals who have established residence in a country cannot relinquish residence

421 Kohl, above n 258, 439.

422 Alley (1995), above n 42, 52.

423 Sheridan, above n 47, 22.

424 Kohl, above n 258, 439 and Sheridan, above n 47, 22.

425 For example, New Zealand requires absence for only 325 days provided there was no permanent place of abode in New Zealand during the period of absence and the person is not engaged in Government service - *Income Tax Act 1994* (NZ) s OE1(3). Also, Arnold and McIntyre in their theoretical model suggest that citizens of a country are residents unless they have established a dwelling abroad and are regularly outside the country for more than 183 days per year – see Arnold, above n 241, 22.

426 *Internal Revenue Code of 1986* (US), s 877(a) removes for 10 years any advantages arising from non-residency from taxpayers who seek to avoid tax by relinquishing United States' citizenship.

427 Above n 20.

428 Bernstein, above n 275, 262.

status until they have established residence status in another country.”⁴²⁹ This approach seeks to ensure horizontal equity by excluding from the tax net those persons subject to residency taxation in other jurisdictions.

In a similar vein, in the 1997 consultant's report, prepared for the ATO's Electronic Commerce Project, it was recommended that:

[c]onsideration be given to changing the definition of individual residence to ensure that previous permanent residents remain residents for a period, say 2 years, after leaving Australia . . . This means that Australians operating from locations offshore might still be liable for Australian tax even though they have escaped being classified as a resident.⁴³⁰

However, this later approach fails the horizontal equity criterion and persons who have establish residency in another jurisdiction will be subject to double taxation.

It must be noted, however, that the mobility of residence in an electronic commerce age will not be stopped by any of the measures discussed (see Part III D 3). Although extended residency ties such as citizenship or domicile appear superficially attractive to capture the fleeing rock star, actor, tennis player, golfer or motor bike racer these tests tend to create complexity and fail to counter systemic non-compliance.

The approach adopted in a number of countries is to create rules that specifically deal with persons fleeing the jurisdiction for tax purposes and/or use extended source rules to tax income with a strong attachment to the jurisdiction.⁴³¹ These rules in turn in the EU have been difficult to enforce as such exit rules are seen as incompatible with the principle of freedom of establishment, as set out in Article 43 of the *European Community Treaty*.⁴³² However, exit taxes and other tax retention strategies are not residency rules, rather, they are anti-avoidance measures aimed at preserving taxing rights outside the operation of the residency rules. Therefore, these retention rules will not be discussed as they are outside the scope of this thesis.

429 Arnold, above n 241, 22.

430 Tyree *et al*, above n 246, Recommendation 6.11.

431 As these persons often visit their "home" jurisdiction an alternative approach advocated by Sharkey is to adopt the "habitual visitor" concept from the United Kingdom or the Canadian "sojourners" concept - Sharkey, above n 243, 7. However, such tests can be inequitable (by capturing regular tourists with little economic attachment to Australia) and are uncertain (being common law or administratively based).

432 *Hughes de Lasteyrie du Saillant v Ministère de L'Économie, des Finances et de l'Industrie* (C-9/02) handed down the European Court of Justice (ECJ) on 11 March 2004.

(b) *Finding the balance*

Thus, on balance, given the failure of the domicile test to meet the evaluative criteria, and the fact that since *Applegate* its policy purpose has been thwarted, the test should be replaced with an objective time limit test so that abandonment is certain. As a two year period was used as an administrative rule in the past, that time period could be used in the test. Such a test will be simpler. To counter blatant manipulation, the test should carry a gloss that Australian residents cannot relinquish residence status until they have established residence status in another country.

However, despite the merits of this suggested reform, the replacement of the domicile concept with a number of days would amount to a major alteration of Australia's jurisdictional claim. Therefore, these improvements cannot be achieved within the jurisdictional framework.

Although the domicile test must remain, the "permanent place of abode" gloss should be amended to restore the original intent of the test, ie that the test does not apply where persons have established a home in another jurisdiction. Therefore, the adoption of the suggested gloss "that Australian residents cannot relinquish residence status until they have established residence status in another country" would have the effect of meeting the original jurisdictional claim and reduce the scope for manipulation. Although this approach is different to the current "domicile test" gloss, it does not appear to practically increase or decrease the original jurisdictional claim. Thus, such a change would more closely meet the "essential objective" of the prevention of tax avoidance, within the intended jurisdictional framework.

3 *Superannuation test*

In Part III it was found that the superannuation test is the one domestic residency rule that is simple and is not able to be easily manipulated. However, the test fails the horizontal equity requirement as it applies inconsistently to tax only some categories of public servants and to treat the spouses and children of public servants differently to other spouses and children.

Further, the test also fails its original intention (ie to extend the scope of the Act to ensure that “. . . the High Commissioners for Australia and Agent-Generals for the Australian States together with members of their staffs, [are] treated as residents . . .” liable for tax as other residents).⁴³³ Also, the scope and relevance of the test long term may be potentially reduced following the enactment on 30 June 2004 of the *Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004* (Cth). This Act provides scope to allow public servants to choose their preferred superannuation fund in the future. If this occurs, the number of persons to whom the superannuation residency test applies will fall conversely. This in turn will increase the number of persons able to avoid the operation of the test by merely choosing an alternative superannuation fund to CSS or PSS.

In order to address these concerns, the options for reforming the superannuation test are examined below, before setting out the recommendations for reform.

(a) *Evaluating options for reform*

Given that:

- entitlement to superannuation is ultimately determined by the CSS and PSS schemes⁴³⁴ residency plays little or no role in that determination; and
- the purpose was to permit locally engaged staff to participate in the superannuation arrangements and they are expressly excluded from membership under both superannuation tests⁴³⁵

there is no further reason for the continued existence of the test. However, as the effectiveness of the domicile test to ensure public servants serving in other jurisdictions remain residents is doubtful following the decision in *Applegate*, consideration must be given to enacting a government employee/service test.

Many countries (including Canada, France and New Zealand) adopted specific government service residency tests (see Part IV C 3(b)). Some countries extend the test

433 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth) 10.

434 See *Superannuation Act 1976* (Cth), s 3(1) and *Superannuation Act 1990* (Cth), s 6(1).

435 Ibid n 70 and 71.

to persons employed in state owned enterprises. However, such tests are driven by the desire of nations to ensure that those persons serving those nations remain residents regardless of their period of absence from their home state.

Leaving aside this political/national imperative, government service tests are difficult to justify in terms of horizontal equity. Although, the tests create horizontal equity between all government workers they perpetuate horizontal inequity between those workers and all other non-resident workers employed by the non-government sector. They do, however, generally satisfy the simplicity criterion.

(b) Finding the balance

On balance, given that the superannuation test no longer fulfils the purpose for which it was introduced, the test should be repealed. Although the repeal may result in a practical reduction in the potential jurisdictional claim, that wider jurisdiction was never intended to be claimed, except in respect of a very narrow class of persons. Thus, the repeal of the test will have the effect of restoring the intended jurisdictional claim and thereby ensure that the domestic law of individual residency more closely meets the “essential objectives” of horizontal equity.

Further, ignoring the operative effect of the current domicile test, a pure resides test will potentially capture public servants working abroad, thereby stemming any potential jurisdiction or revenue loss. If a government service rule was to replace the superannuation test, the test would increase horizontal inequity as more public servants would be treated differently to other employees. However, although the government service rule may be justifiable on Government policy reasons, it is difficult to justify in the context of the evaluative criteria.

In summary, within the strict criteria of the sub-thesis the repeal of the superannuation test would amount to a minor variation in the jurisdictional claim. However, as this extension was not part of the intended jurisdictional claim, its removal will ensure that the domestic law of individual residency more closely meets the “essential objectives” of horizontal equity, within the intended jurisdictional framework.

4 Resides test

The resides test under s 6(1)(a) of the 1936 Act results in horizontal inequity, is complex and is open to manipulation (see Part III). In order to address these concerns, the options for reforming the resides test are examined below, before setting out the recommendations for reform.

(a) *Evaluating options for reform*

Countries such as the United States, have responded to the concerns about complexity and avoidance⁴³⁶ arising under fact and circumstance tests by replacing them with specific criteria tests (eg citizenship)⁴³⁷ and/or specific time period tests (eg New Zealand and Norway)⁴³⁸ (see Part IV). Thus, simplicity has been put ahead of the full consideration of an individual's personal circumstances.⁴³⁹

Despite the adoption of more objective tests, most countries, even in the reform context, have retained limited fact and circumstance tests (see Part IV C 1). The reasons for countries retaining such tests vary, but in the main it is concerns that pure presence tests will often fail to capture persons who otherwise have strong attachment to the jurisdiction.⁴⁴⁰

A “fact and circumstances” test is even used in the OECD Model Convention's tie-breaker test (ie the concept of permanent home (dwelling)). This concept is narrower

436 McIntyre, above n 367.

437 *The Deficit Reduction Act 1984* (US) Introduced the statutory definition of United States resident - see Leonard W Rothschild Jr and Michael G Schinner, ‘United States: Determining residency for Federal income tax purposes’ (1993) 47 *Bulletin for International Fiscal Documentation* 85.

438 See, eg, Norway has changed from an “intention” basis to an factual test tiered test based upon a number of days, with loss of residency occurring if: the person does not have a permanent home; residency is established in another state; and less than 61 days is spent in Norway - see Zimmer, above n 373. Also Chartered Institute of Taxation (UK), which in commenting on proposed United Kingdom enquiry into individual residency rules, recommended the replacement of the resides test with a test based upon the number of days present in the United Kingdom coupled with a weighted average test in respect of prior year presence - see Chartered Institute of Taxation (UK) *Reviewing the Residence and Domicile Rules as they Affect the Taxation of Individuals: A Background Paper*, 1 August 2003, para 8.2. This is consistent with the recommendations of the United Kingdom, *Final Report of the Royal Commission on the Taxation of Profits and Income* Cmd 9474 (1955), para 292. The Commission viewed the devotion by Inland Revenue of a great deal of time and skill in considering and adjudicating upon individual residency cases as the major reason for the adoption of fixed rules to determine residency.

439 Ibid 1955 United Kingdom Royal Commission on the Taxation of Profits and Income and Davies, above n 45, 25.

than residence, focusing on the existence of accommodation for permanent use (see Part II C 2(b)(i)). Therefore, although it suffers from the complexity and avoidance issues of all fact and circumstance tests (see Part IV C 3(a)), its narrower focus on the existence of accommodation makes it easier to apply than a resides test. This test also has the advantage of being consistent with the residency rules in many countries and with the OECD Model Convention.

(b) *Finding the balance*

In order to counter avoidance and to ensure horizontal equity, a facts and circumstance “resides” test of some form needs to be retained. It is argued that the current resides test should be retained due to the inherent flexibility of the resides concept (“... as society’s perceptions change, so will the notion of residence”), which helps to counter tax avoidance.⁴⁴¹ By taking account of family circumstances, the “resides” rule catches those who seek to place their families in a country offering a better environment for their families, while at the same time avoiding the residency downside (and paying for those advantages) by keeping income earning assets outside the jurisdiction’s tax net.

However, despite these claims, the resultant complexity is not fully compensated by this flexibility as the resides test is only likely to evolve at the margins. Therefore, it is unlikely that this evolution will result in a new concept that will counter the mobility problems, facilitated by the growth in electronic communication.⁴⁴²

The residency tests used in other jurisdictions do give a range of alternative tests that could simplify the law, however, simplicity is generally achieved through narrowing the intended jurisdiction claim. Therefore, within the terms of the sub-thesis, the resides test cannot be modified to better meet the evaluative criteria without creating a major variation to the jurisdictional claim.

440 Sharkey, above n 243, 8 notes that many prescriptive rules tend to focus on the individual and thereby often fail to capture such persons.

441 Gzell (1996), above n 11, 8.

442 Ibid, 9. Prebble, above n 192, 389 notes that as people’s mobility make it more difficult to refine residency rules to pure physical location, jurisdictions in defining their residency rules have adopted physical facts, metaphysical facts (such as intention) and resort to formal, arbitrary criteria where dual residency occurs. Thus, “[t]he arbitrariness of residency rules results . . . from practical difficulty, not from conceptual impossibility.”

5 Other definitions

Contained within the tax laws and related legislation there exist a number of specific residency definitions and other rules that impact upon the scope of the s 6(1) rules (see Part II B). They include:

- s 23AG of 1936 Act, which provides an exemption with progression for income arising from continuous foreign service;
- the term “ordinarily resident” is used in ss 23(a)(ii), 23(v), 23AA, 128J(1)(b), 251U(1)(e), 252(3)(b), 252A(2A)(b) of the 1936 Act and in number of DTAs;
- the “Territory resident” test exists in Division 1A of Part III of the 1936 Act, which provides the basis for Norfolk Island residents to be exempt from tax on income derived from sources in and outside of the Territory;
- a “resident taxpayer” as defined in s 3(1) of *Income Tax Rates Act*, which enables, in certain circumstances, a non-resident who receives government benefits is taxed at resident rates; and
- an “Australian resident” is defined in s 3(1) of the *Health Insurance Act 1973* (Cth), to determine who is entitled to Medicare benefits.

The ordinarily resident and territory resident facts and circumstance tests fail to deliver horizontal equity (as they can result persons in similar circumstances having different residency status) and are not simple (ie lack predictability, impose compliance and administrative burdens) (see Part III A 1 and C). The continuous foreign exemption (s 23AG of the 1936 Act) lacks simplicity by carrying high compliance costs, while the *Income Tax Rates Act* and the *Health Insurance Act* residency definitions rules, although targeted to certain policy outcomes, are not coordinated with other definitions leading to unnecessary complexity.

(a) *Evaluating options for reform*

Other than the “ordinary” resident test, the other specialist residency tests are policy specific to Australia, thereby limiting the scope for comparison with other jurisdictions. Further, there are limitations on the avenues to reform some of the specific residency tests, as alterations to the definitions in the Medicare and *Rates Act* could impact upon

social security and health policy. For example, if special definitions used to determine liability to the Medicare levy and entitlement to the benefits of that levy were matched, complexity would be reduced but this would impact upon both health policy and possibly Government revenue.

This is not the case with “ordinary” resident. The difference between the terms “resident” and “ordinary resident” is subtle.⁴⁴³ However, despite this subtlety, Dixon J in *Gregory v Deputy Commissioner of Taxation (WA)* when considering the meaning of the word “resident” in s 5A of the *Income Tax Assessment Act 1922-1934* (Cth) did not differentiate, stating that the word resident “. . . should receive the same meaning and application as “person residing” and “ordinary resident” have been given in England.”⁴⁴⁴ Further, given that the ordinary residence concept does not determine liability (as it does in the United Kingdom and Ireland (see Part IV B 2)) the subtle difference is of lesser importance in Australian law. Therefore, the “ordinarily resident” tests in ss 23(a)(ii), 23(v), 23AA, 128J(1)(b), 251U(1)(e), 252(3)(b), 252A(2A)(b) of the 1936 Act could be replaced with the resides test without dramatically altering the scope or intent of the sections.

Similarly, the words “ordinary place of residence” in the “Territory resident” definition in s 24C of the 1936 Act could use the “resides” test without dramatically altering the scope or intent of the section. These changes would create consistency and lessen complexity by removing unnecessary definitions.

(b) *Finding the balance*

On balance, the “ordinarily” resident and “ordinary place of residence” tests could be replaced in the 1936 Act by the “resides” test, in order to create consistency and lessen complexity. The effect of these changes would be that the domestic law of individual residency, within the broad jurisdictional framework, will more closely meet the “essential objective” of simplicity.

443 United Kingdom Codification Committee, above n 78, 38 noted that it is impossible to accept that the words describe the same degree of residence.

444 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774, 777; 4 ATD 397, 399; 1 AITR 201, 202.

Australia's DTAs have been developed in the main over the last 58 years through country by country negotiation, the tie breaker tests adopted and the order in which they appear varies from DTA to DTA (see Part II C). This variation in wording creates inconsistency and complexity. Also, a lack of horizontal equity inherently arises from the existence of DTAs, as only resident of the States that are parties to the treaty can avail themselves of the DTA tie breaker test. As a result some dual resident migrant individuals in a DTA country will be treated differently to those dual resident individuals from non-DTA countries.

(a) Evaluating options for reform

As discussed above, the horizontal inequity issue should be short term, as the Government is escalating Australia's future treaty negotiation program. However, the variations in the form of residency tests in each treaty (resulting in part from a failure to adopt the OECD model residency article) and with the vagueness of the terms used in the various tests are longer term problems. This idiosyncratic approach to wording in Australian DTAs can only lead to interpretative issues, particularly where there is wide divergence from the OECD Model Convention. Such variations also tend to slow the DTA negotiation/renegotiation process. As a result such arbitrary departures tend to counter the simplicity objective.

(b) Finding the balance

As Australia's DTAs generally follow the OECD Model Convention the only change required would be to ensure that in treaty negotiations the tie breaker tests are equivalent to those in Article 4 of the OECD Model Convention. Over time, as treaties are renegotiated, the effect of this change in treaty policy will be that the law of individual residency, within the jurisdictional framework, will more closely meet the "essential objective" of simplicity.

7 Miscellaneous changes

Finally, there are some minor changes which if adopted may improve simplicity without adversely impacting upon the other policy objectives.

First, as noted in Part II, there is a lack of clarity about the operational order of the various residency tests in s 6(1) of the 1936 Act (ie a lack of hierarchy). This lack of clarity arises as the 1930 Explanatory Notes appear to indicate that the common law test has primacy in application,⁴⁴⁵ while the courts tend to apply the specific statutory tests (ie the domicile, 183 day or Commonwealth superannuation tests) prior to or in conjunction with the general common law resides test. Thus, simplicity is reduced as the interrelationship between the primary residency rules is unclear.

The creation of a formal hierarchy of tests is a structural change, which would aid simplicity (by creating certainty) while not impacting on the other tax policy objectives. A recommended structure would be to order the statutory the tests, stating with the attachment rule (183 day tests), followed by the cessation rule (domicile test) and the special criteria rules (superannuation test and possibly some of the specific purpose tests such as the “Territory resident” test). The resides test, if retained will continue as a catch all test.

A second minor change would be to rewrite the residency rules in the “plain” English gender neutral style, consistent with the language of the 1997 Act and relocate the revised definition in the 1997 Act. This would also result in increased simplicity as the language, would be consistent with the 1997 Act, and compliance costs for tax professionals would be reduced as the tests would be contained in the principal 1997 Act.

Thus, these two minor changes will have the effect of ensuring that the domestic law of individual residency, within the jurisdictional framework, more closely meets the “essential objectives” of simplicity.

445 Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 9.

C. Summary

In the above analysis each of the Australian residency rules has been examined to determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. It has been recommended that the superannuation test should be repealed and the ordinary resident test removed. Although changes to the resides, 183 day and the domicile tests have been recommended, only those minor changes which do not extensively modify the jurisdictional claim can be adopted. These changes, combined with some technical alternations will result in the individual residency rules better meeting the evaluative criteria. However, greater improvement could be achieved through more major variations to the jurisdictional claim.

VI. Conclusions

A. The main thesis

The purpose of the analysis in Parts II and III of this Chapter was to establish the main thesis in respect of the residency rules applicable to individuals, that is:

The law, as applying in the 1997 Act, is inadequate as the law fails in its practical application to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

In Part II of the Chapter, the scope of the residency rules for individual residency was explored, covering:

- the principal rules (resides, domicile, 183 day and superannuation tests) in s 6(1) of the 1936 Act;
- the other residency tests (continuous foreign service exemption, other definitions (ordinarily, Territory and foreign residents) and definitions in other Acts); and
- the impact of the DTA tie breaker tests.

These tests were evaluated in Part III against the evaluative criteria (equity, efficiency, simplicity and the prevention of tax avoidance). Overall they fail in identified ways to

satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criterion. The superannuation test, which is the only rule that satisfies both the simplicity and tax avoidance criteria, failed the horizontal equity requirement. For the balance of the residence tests for individuals (resides, domicile, 183 day, Territory resident and ordinarily resident tests and elements of the DTA tie breaker tests) the major weakness is the individual facts and circumstances element of the tests in certain situations which:

- results in horizontal inequity;
- gives rise the lack of simplicity; and
- leaves the rules open to manipulation.

Further, although the facts and circumstances element of the tests does cater for an individual's circumstances, it does mean that there is horizontal equity. These problems arise in part from the fact that the law has not been formulated from basic principles, rather it has arisen from “. . . the accidents of political and commercial considerations in past history . . . perpetuated”.⁴⁴⁶

Thus, it has been established that residency rules applicable to individuals in the 1997 Act are inadequate as the law fails in its practical application to satisfy the “essential objectives” of equity, efficiency, simplicity and the prevention of tax avoidance.

B. The sub-thesis

The purpose of the analysis in Parts IV and V of this Chapter was to establish the sub-thesis in respect of the residency rules applicable to individuals, that is:

The domestic law can be modified within the jurisdictional framework to more closely meet the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

In the above Part IV a comparative review of the residency rules adopted domestically in a number of jurisdictions was undertaken in two stages. Initially, the review looked at the residency rules for individuals in the context of each country's tax system. The

446 Sir Josiah Stamp, *The Fundamental Principles of Taxation in the Light of Modern Developments* (1936) 25.

countries examined were divided into common law countries that tax through a single code, common law countries that operate on a schedular system and the European civil law countries. The purpose of this contextual review was to provide a comparison of the of residency tests adopted in the context of the legal systems of each country. This contextual comparison could not be demonstrated by merely evaluating the categories of residency rules on a rule-by-rule basis.

However, the contextual review merely confirms that nations set their residency rules based upon each jurisdiction's own economic and social value judgments. Whether a jurisdiction adopts "fact and circumstance" criterion or more objective criteria does not have any relevance to the basis of the legal system (civil or common law) nor to the structure of the tax codes (single code or schedular code).

The second stage of the comparative review examined the foreign domestic residency rules against the evaluative criteria on a rule-by-rule basis. This was done by comparing and evaluating the individual residency test within the three broad approaches adopted world wide (individual facts and circumstances tests, arbitrary number of days tests, and specific criteria tests) to determine a connection to a jurisdiction.

What emerged from this second stage of the comparative review is that the residency rules adopted world wide, like the rules operating in Australia, are unable to satisfy all the evaluative criteria. Another outcome of the study was that although there were a number of similarly named tests, often the tests were structured differently from jurisdiction to jurisdiction.

Finally in Part V, changes to the current Australian residency rules were explored to determine whether modifications to the rules would better satisfy the evaluative criteria. The reform recommendations arising are set out in the following.

1 183 Day Test

In light of the need to counter avoidance and the resultant simplicity it is recommended that the 183 day test be revised to change the measurement period to any 12 month period, rather than a tax year. However, further changes to increase simplicity by

repealing pre DTA 183 day test glosses (ie the “usual place of abode” and the “intention” glosses) cannot be adopted as the change would amount to a major variation of Australia’s jurisdictional claim.

Despite the inability to alter the glosses, the change to the measurement period should result in a test which is simple, less easy to manipulate and does not create major horizontal inequities. The test, as modified, will have the effect of ensuring that the domestic law of individual residency, within the broad jurisdictional framework, more closely meets the “essential objectives” of equity, efficiency, simplicity and the prevention of tax avoidance.

Further technical amendments could also add further simplification. First, the law should be amended to clarify how the period is calculated by defining what time period constitutes a day (ie whether part of a day constitutes a day). Also, the law needs to be amended to clarify that under the 183 day test residency commences from date of arrival in Australia. As a result the effect of these changes will ensure that the domestic law of individual residency, within the jurisdictional framework, more closely meets the tax policy objective of simplicity.

2 Domicile test

Given the failure of the domicile test in s 6(1)(a)(i) of the 1936 Act to meet the evaluative criteria, and the fact that since *Applegate* its policy purpose has been thwarted, it was suggested that the test should be replaced with an objective time limit so that the point of abandonment is certain. However, despite the merits of this suggested reform, the replacement of the domicile concept with a number of days would amount to a major alteration of Australia’s jurisdictional claim.

It was recommended, however, that although the domicile test must remain, the “permanent place of abode” gloss should be amended to restore the original intent of the test, ie that the test does not apply where persons have established a home in another jurisdiction. The adoption of the gloss that Australian residents cannot relinquish residence status until they have established residence status in another country would have the effect of meeting the original jurisdictional claim and reduce the scope for

manipulation. Thus, such a change would more closely meet the “essential objective” of the prevention of tax avoidance, within the intended jurisdictional framework.

3 Superannuation test

Ignoring the operative effect of the current domicile test, a pure resides test will potentially capture public servants working abroad. Therefore, the repeal of superannuation test will not impact upon the jurisdictional claim. Further, the repeal of the test will have the effect of ensuring that the domestic law of individual residency, within the intended jurisdictional framework, more closely meets the “essential objectives” of horizontal equity.

As the resides test will potentially capture public servants working abroad, there is no need for a government service rule to replace the superannuation test. Such a test would increase horizontal inequity, as more public servants would be treated differently to other employees. Although the government service rule may be justifiable on Government policy reasons, it is difficult to justify in the context of the evaluative criteria.

4 Resides test

The review of the residency tests in other jurisdictions revealed a range of alternative tests that could simplify the law. However, simplicity is generally achieved through narrowing the jurisdiction claim. Given that the reform solution in terms of the sub-thesis should not limit the jurisdictional claim, none of the alternatives are viable. Therefore, the test cannot be modified within the jurisdictional claim to better meet the evaluative criteria.

5 Other definitions

On balance, it is concluded that the terms “ordinary resident” and “ordinary place of residence” could be replaced in the 1936 Act by the resides test which would create consistency and lessen complexity by removing unnecessary definitions. The effect of

these changes is that the domestic law of individual residency, within the jurisdictional framework, will more closely meet the “essential objective” of simplicity.

6 DTAs

As Australia’s DTAs generally follow the OECD Model Convention the only change would be to ensure that in treaty negotiations, the tie breaker tests are equivalent to those in Article 4 of the OECD Model Convention. The effect of these changes is that the law of individual residency, within the jurisdictional framework, will more closely meet the “essential objective” of simplicity.

7 Miscellaneous changes

The creation of a formal hierarchy of tests is a structural change, which would aid simplicity (by creating certainty) while not impacting on the other tax policy objectives. A recommended structure would be to order the statutory tests, starting with the attachment rule (183 day tests), followed by the cessation rule (domicile test) and the special criteria rules (superannuation test and possibly some of the specific purpose tests, such as the “Territory resident” test). The resides test, if retained, will continue as a catch all test.

A second minor change would be to rewrite the residency rules in the “plain” English gender neutral style consistent with the language of the 1997 Act and relocate the revised definition in the 1997 Act. This would also result in increased simplicity as the language would be consistent with the 1997 Act, and compliance costs for tax professionals reduced as the tests would be contained in the principal 1997 Act.

Thus, these two minor changes will have the effect of ensuring that the domestic law of individual residency, within the jurisdictional framework, more closely meets the “essential objectives” of simplicity.

Thus, although not every individual residency test is able to be amended, overall it has been established that residency rules applicable to individuals in the 1997 Act, if modified within the jurisdictional framework as recommended, will more closely meet

the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

Chapter 4

Residency of companies and trusts

1. Purpose of this Chapter

Having evaluated in Chapter 3 the domestic residency rules applicable to individuals in terms of the main thesis and sub-thesis, the focus of this Chapter is to similarly evaluate the residency tests for companies and trusts in the context of both the thesis and sub-thesis. Although it has been argued that the concept of permanent establishment (which sets the threshold for countries to impose source-based taxation of business income¹) should be treated as akin to a residency rule,² that rule of attachment will be examined in the context of source taxation in Chapter 5.

As the residency rules for companies and trusts under the tax laws are distinct (reflecting their differential tax treatments) they will be examined separately.³ Thus, in Part II the operation of the residency rules relating to companies will be explored in order to provide the necessary basis to enable evaluation of those rules against the evaluative criteria of equity, efficiency, simplicity and prevention of tax avoidance (in Part III).

Parts IV and V of the Chapter explore the sub-thesis (ie alternative approaches to the current rules that may better satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance) through the use of comparative studies of the domestic approaches to company residency adopted in other jurisdictions. However, as in Chapter 3, this latter analysis will be restricted to the domestic residency

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- 1 Michael J Graetz 'Taxing international income: Inadequate principals, outdated concepts, and unsatisfactory policies' (2001) 26 *Brooklyn Journal of International Law* 1357, 1421. Robert Couzin in *Corporate Residence and International Taxation* (2002), 4 notes that "permanent establishment" is the means by which a state taxes an item of income, earned by persons who do not exhibit the nexus for residence taxation, as if the income was earned by a resident. This is justified on the basis that the income is of a kind that establishes a secondary nexus sufficient to warrant this treatment.
 - 2 Kerrie Sadiq, 'Jurisdiction to tax and the case for threshold reform' (Paper presented at the 16th Australasian Tax Teachers Association Conference, Adelaide, 30 January 2004), 2.
 - 3 The order of discussion reflects the importance of each category to the tax system, ie in 2001-02 648,504 company returns were lodged disclosing net tax liability of \$27.6 billion, while only 455,980 trusts were lodged – see Australian Taxation Office, Commonwealth, *Taxation Statistics 2001-02* (2004) 51 and 90.

rules. DTAs will not be compared as the Australian DTAs are based upon the OECD Model Convention and the variations away from the OECD Model are identified in the analysis of DTAs in the various Parts of the Chapter.

This process will be repeated for trusts, with Part VI exploring the operation of the residency rules relating to trusts, which will provide the necessary basis to enable review of those rules against the evaluative criteria of equity, efficiency, simplicity and prevention of tax avoidance (in Part VII). Where the residency tests for trusts have common features, discussion will not be repeated; rather the discussion will focus on the specific features of the test in that context. In Part VIII a comparative analysis in respect of trusts will be undertaken, followed by analysis of reform options (in Part IX) in light of the evaluative criteria in order to determine whether the proposed reforms deliver more equity, efficiency, simplicity and are more able to prevent tax avoidance.

Finally, the findings and recommendations made within the chapter are summarised in Part X.

II. Exploring the Main Thesis – Scope of the residency rules for companies

As mentioned above, the preliminary step in evaluating the main thesis is the need to explore the scope of the residency rules applicable to companies. This first involves exploring the principal residency tests contained in s 6(1) of the 1936 Act before exploring the other residency definitions and rules that impact or alter the scope of the those principal residency tests in specific circumstances. Finally, as the domestic residency definitions can be overridden by the residency tie-breaker test contained in most Australian DTAs, for completeness it is important to explore the impact of DTAs on the scope of the domestic residency rules.

Prior to exploring the scope of the principal residency rules applicable to companies, the preliminary step is to define what a company is in this context.

A. Defining a company

A “company” for the purposes of the 1997 Act is defined in s 995-1 as:

- (a) a body corporate; or
- (b) any other unincorporated association or bodies of persons;
but does not include a partnership or a non-entity joint venture.⁴

This definition is wider than the definition of “company” under the *Corporations Act 2001* (Cth),⁵ and includes within the definition unincorporated bodies like football clubs and political parties. Also, “corporate limited partnerships”,⁶ “corporate unit trusts”⁷ and “public trading trusts”⁸ are treated as companies under the 1936 and 1997 Acts

B. Defining the scope of the principal residency test for companies

The exploration of the scope of the principal residency rules applicable to companies contained in s 6(1) of the 1936 Act will be undertaken by first providing an overview of the rules and their interrelationship before exploring the scope of each of the rules in detail.

1 Overview of the principal residency rules

An “Australian resident”, as defined in s 995-1 of the 1997 Act, is a person (including a company) who is a resident under the 1936 Act. The principal company residency tests are in s 6(1)(b) of the 1936 Act, which states that a:

“resident” or “resident of Australia” means . . .

(b) a company which is

- * incorporated in Australia, or
- * not being incorporated in Australia, carries on business in Australia and has either:
 - * its central management and control in Australia, or

4 An “entity” is defined in s 960-100(1) of the 1997 Act to include “. . . (b) a body corporate . . . (e) any other unincorporated association or bodies of persons”. It is these entities that are liable for tax under the Act (s 9-1).

5 *Corporations Act 2001* (Cth) s 9.

6 1936 Act s 94.

7 1936 Act Division 6B - ss 102D to 102L.

8 1936 Act Division 6C - ss 102M to 102T.

- * its voting power controlled by shareholders who are residents of Australia;

Thus, the definition contains alternative three statutory tests for determining residency: an “incorporation” test, a “central management and control” test and a “voting power control” test. Thus, the definition deems residency if the place of creation is in Australia or where the place of business activity is Australia and its management is in Australia or its ownership is Australian. This is the same company test adopted in the 1930's when the Commonwealth⁹ and some states¹⁰ introduced the residency basis of taxation. On repeal of the 1922 Act the company definition was incorporated unchanged into the 1936 Act.¹¹

The scope of the alternative three statutory tests in s 6(1)(b) of the 1936 Act for determining company residency (the incorporation, central management and control and voting power control tests) are explored in the following paragraphs.

2 *The scope of the incorporation test*

The first statutory test for corporate residency is “whether the company was incorporated in Australia”. The test means that “... incorporation in Australia in itself [is] decisive of residence . . .”,¹² reversing the common law presumption that incorporation will not be decisive in determining residency.¹³ The test was designed to capture companies “incorporated in Australia to operate outside Australia” and to ensure that residency could be determined regardless of where “the head office of control may be situated”.¹⁴

9 This definition of a resident company was first introduced into the *Income Tax Assessment Act 1922* (Cth) via s 2(i)(b) of the *Income Tax Assessment Act 1930* (Cth).

10 For example, a residency basis of taxation was introduced in South Australia via s 4 of the *Taxation Act 1931* (SA) and in Victoria via s 2 of the *Income Tax Acts Amendment Tax Act 1931* (Vic). Tasmania also followed suit while Queensland fully exempted ex-Australian income. In New South Wales ex-Australian income was only partially taxed (income from non-investment trade or business), as was ex-Australian income in Western Australia (export income).

11 1936 Act s 6(1)(b).

12 *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) 64 CLR 241, 251; 2 AITR 167, 174; 6 ATD 42, 45 (Williams J).

13 See eg *De Beers Consolidated Mines v Howe* (1906) 5 TC 198, 212-213 (Lord Loreburn LC) and *Todd v Egyptian Delta Land Investment Co Ltd* [1929] AC 1, 14 (Viscount Sumner). As see Couzin, above n 1, 29-55 for a history of the presumption.

14 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 11.

The theoretical basis for the incorporation test is the view that by giving the company its existence and the advantages of incorporation in the jurisdiction, the quid pro quo for the company is taxation as a resident (ie a tax loyalty argument).¹⁵ There are also traditional, practical reasons for the “incorporation” test. As the owners of a company would normally incorporate a company in their place of residence, it is appropriate that the location of company residency be that of its owners. Thus, “the consequences that follow from being treated as a resident are the quid pro quo for the privilege of incorporation”.¹⁶

As “company” is defined in s 995-1 of the 1997 Act to include “. . . any other unincorporated association or bodies of persons” not all companies are caught within this test.

3 *Central management and control test*

(a) *Overview*

The second statutory test in s 6(1) of the 1936 Act, the central management and control test, has been adopted from the common law of the United Kingdom.¹⁷ The definition was intended to apply “. . . to companies . . . whose central management and control is in Australia” thereby ensuring that a “. . . number of companies incorporated outside Australia whose sole or principal business is located in Australia” were taxable as residents.¹⁸

The test’s theoretical origins lie in the “. . . chief and principal place of business activity and social life”¹⁹ criterion under the common law tests for the residency of individuals.²⁰

15 Roger Hamilton, Robert Deutsch and John Raneri, *Australian International Taxation* (October 2002), para 2.180.

16 Richard Vann, ‘Central Management and Control: Do We Need It’ (Paper presented at the ATO Advanced Workshop on Residency, Sydney, 31 August 1995), 7.

17 Taxation Review Committee, Commonwealth, *Full Report* (1975) (Asprey Report), 255.

18 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 11.

19 This factor is illustrated in *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774; 1 AITR 201; 4 ATD 397.

20 *De Beers Consolidated Mines v Howe* [1906] AC 455, 458; (1906) 5 TC 211, 212-213 (Lord Loreburn LC) stated, “. . . in applying the concept of residence to a company, we ought, I think, to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business.”

This rationalisation was accepted by the High Courts decision in *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation*²¹ where Starke J noted that:

It is unnecessary for me to traverse again the “weary road of the tax cases.” A company may be a “resident” for the purposes of Income Tax Acts and it may have more than one residence for the purposes of these Acts. A company resides “wherever it keeps house and does business.” . . . If its central management and control abide in a particular place the company resides there for the purposes of income tax.

The test is in some ways akin to a source rule in that the place of closest economic connection with the company’s income is likely to be the place of central management and control.²²

The test appears on its plain reading to consist of two elements: the first element is that the company must be carrying on business in Australia and the second element is that it must have its central management and control in Australia. Before examining the scope of each element of the central management and control test, it is important to determine whether the first element (carries on a business) has an independent role in terms of the test, in light of conflicting legal interpretation that calls into question its independent operation.

(b) *Is the “carries on business in Australia” element relevant?*

The High Court in *Malayan Shipping Co v Federal Commissioner of Taxation*²³ found that once central management and control was established, it would be inferred that a business is being carried on. As Williams J noted:

In *Mitchell v Egyptian Hotels Ltd* [1915] AC 1022, at p 1073 Lord Parker of Waddington said: “Where the brain which controls the operations from which the profits and gains arise is in this country, the trade or business is, at any rate partly, carried on in this country.” The purpose of requiring that, in addition to carrying on business in Australia, the central management and control of the business or the controlling shareholders must be situate or resident in Australia is, in my opinion, to make it clear that the mere trading in Australia by a Company not incorporated in Australia will not of itself be sufficient to cause the company to become a resident of Australia. *But if the business of the company carried on in Australia consists of or includes its*

21 (1941) 64 CLR 241, 246; 2 AITR 167, 170; 6 ATD 82, 85.

22 Richard Vann, ‘Prologue’ in Richard Vann (ed), *Company Tax Reform* (1988), ixxvii.

23 (1946) 71 CLR 156; 8 ATD 75; 3 AITR 258.

central management and control, then the company is carrying on business in Australia and its central management and control is in Australia.²⁴
[Emphasis added]

Justice Dixon also expressed a similar view in *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation*. Justice Dixon stated that:

[i]n the first place, it is well to remember that the basal principal is that a company resides where its real business is carried on and that is for the purpose of ascertaining where that is that the subsidiary principal is invoked that the place where the superior direction and control is exercised determines where the real business is carried on.²⁵

Despite the “carries on business” element of the test has been broadly accepted as otiose,²⁶ there are those who believe that “. . . to be resident it must be positively shown that the acts of management and control are genuinely accompanied by acts of carrying on business.”²⁷ Similarly, the 2002 Review of International Taxation Arrangements (RITA) Consultation Paper notes that the case law is not entirely clear and illustrates the uncertainty by revealing that the Commissioner applies the test so that the carries on business element is separate to the central management and control element.²⁸

In light of this uncertainty, and recommendations by the Board of Taxation in 2003 to repeal the central management and control test,²⁹ the Government sought the release of a

24 (1946) 71 CLR 156, 159; 8 ATD 75, 77; 3 AITR 258, 261.

25 (1946) 71 CLR 623, 629; 8 ATD 121, 125; 3 AITR 314, 319. Also see *San Paulo (Brazilian) Railway Company v Carter* (1895) 3 Tax 407, 410 (Lord Halsbury LC) who noted that the phrase “where trade is carried on” has two meanings: one being where the day to day business is conducted (“. . . where things corporeally exist or are dealt with”), the other the place where “. . . the conduct and management, the head and brain of the trading adventure” is located which may be different.

26 Asprey Report, above n 17, 255, NE Challoner and JM Greenwood *Income Tax Law and Practice (Commonwealth)* (2nd ed, 1962), 42, Uta Kohl, ‘The Horror-Scope for the Taxation Office: The Internet and its Impact on ‘Residence’” (1998) 21 *University of New South Wales Law Journal* 436, n 45, Tom Magney ‘Australia-Singapore Taxation Aspects of Carrying on Business in Singapore – Part II’ (1975) 4 *Australian Tax Review* 67, 69, Sadiq, above n 2, 9 and Richard Vann and Ross Parsons, ‘The foreign tax credit and reform of international taxation’ (1986) 3 *Australian Tax Forum* 131, 148.

27 See eg Hamilton, above n 15, para 2.190. Similarly, AJ Baldwin and JAL Gunn, *Income Tax Laws of Australia* (1937) 168, notes that “if the business of the company carried on in Australia consists of or includes its central management and control,” then the company is a resident. Although John Vincent Ratcliffe, John York McGrath and JWR Hughes, *The Law of Income Tax (The Commonwealth)* (1938), 105-6 recognises that the words “carries on business” could be redundant, the authors suggest that the phrase could be used “. . . in the sense of ‘carries on its trade or other operations in Australia’ as distinct from the management and control of those operations.”

28 The Treasury, Commonwealth, *Review of International Taxation Arrangements* (2002) 54 (RITA Consultation Paper).

29 Board of Taxation, Commonwealth, *International Taxation: A Report to the Treasurer* (2003) 109 (Recommendation 3.12).

taxation ruling to clarify the operation of the test.³⁰ The Commissioner responded confirming that the test was a two tier test in Taxation Ruling TR 2004/15, *Income Tax: Residence of Companies Not Incorporated in Australia – Carrying on Business in Australia and Central Management and Control*.³¹ Given the importance of this issue it is crucial to examine the Ruling in order to evaluate whether the Commissioner has established that the “carries on business” element of the test is still an independent test.

The Ruling argues that on both precedent and statutory interpretative grounds, the two elements of the test are in fact distinct elements which must both be satisfied for the residency to be found.

The statutory interpretation arguments are that the two elements of the test are separate requirements under the basic rules of statutory interpretation as:

- the plain words of an Act must be given full meaning and effect;³²
- courts should not easily consider any word or sentence used in an Act as superfluous or of limited meaning;³³ and
- that judicial statements regarding the construction of an Act must never supplant or supersede the actual words of the statute itself. Ultimately, each case must be governed by the Act and not judicial formulae.³⁴

The second line of argument is based upon distinguishing the precedent value of *Malayan Shipping* and other cases. The Ruling initially seeks to argue, by implication, that *Malayan Shipping* should be limited to its facts. It argues that Williams J’s

30 Treasurer ‘Review of International Taxation Arrangements’ (Press Release No 32, 13 May 2003).
31 The draft of this Ruling (Draft Taxation Ruling TR 2004/D7, *Income Tax: Residence of Companies Not Incorporated in Australia – Carrying on Business in Australia and Central Management and Control*) was released on 23 June 2004 for public comment, with public comment required by 6 August 2004. The Ruling issued as a final on 20 October 2004.
32 Taxation Ruling TR 2004/15, *Income Tax: Residence of Companies Not Incorporated in Australia – Carrying on Business in Australia and Central Management and Control*, para 28 citing *Broken Hill South Ltd (Public Officer) v Commissioner of Taxation (NSW)* (1937) 56 CLR 337, 371; 1 AITR 106, 126; 4 ATD 163, 180 (Dixon J) and *Jackson v Secretary, Department of Health* (1987) 75 ALR 561, 571 (Northrop J).
33 TR 2005/15, *ibid*, para 28 citing *Project Blue Sky Inc v Australian Broadcasting Authority* (1998) 194 CLR 355 and *Beckwith v R* (1976) 135 CLR 569. In *Beckwith* at 574, Gibbs J stated that, ‘[a]s a general rule a court will adopt that construction of a statute which will give some effect to all the words which it contains’. Also see *Chaudhri v Federal Commission of Taxation* (2001) 47 ATR 126, 128; 2001 ATC 4214, 4216.
34 TR 2004/15, *ibid*, para 38 citing *Paisner v Goodrich* [1955] 2 QB 353, 358, *John v Federal Commissioner of Taxation* (1989) 166 CLR 417; 20 ATR 1; 89 ATC 4101, *Ogden Industries Pty*

comments (cited above) are explicable in the context of *Malayan Shipping* as in the case there was no need to examine the carries on business requirement due to the fact that the two separate requirements in the second statutory test were met by the same set of facts and activities.³⁵ Also, it is argued that the extract from *Mitchell v Egyptian Hotels Ltd*, cited in *Malayan Shipping* by Williams J (see above), only indicates that mere trading is not sufficient to establish residency (ie there must also be central management and control). It does not support the further proposition that if you have central management and control you are also invariably carrying on a business in that jurisdiction.³⁶

As a result, the Ruling concludes that only where a company's business is management of its investment assets, and it undertakes only minor operational activities (as in *Malaysan Shipping*), will the factors that determine where a company is carrying on a business be similar to those determining where it is exercising central management and control. It is only in that situation that the location of central management and control may be indicative of where the company carries on business.³⁷

The Ruling then seeks to limit the precedential value of other decisions by arguing that:

- the Australian cases on central management and control, apart from *Malayan Shipping*, do not turn on the residence of the company under the second statutory test (including *North Australian Pastoral Co Ltd*), rather they considered provisions requiring a person to be a 'resident' in a particular place;³⁸
- although the statement by Lord Loreburn in *De Beers Consolidated Mines Ltd v Howe* "... that a company resides where its real business is carried on ... and the real business is carried on where the central management and control actually

Ltd v Lucas [1970] AC 113, 127 (Lord Upjohn) and *Brennan v Comcare* (1994) 50 FCR 555; (1994) 122 ALR 615, 634.

35 Ibid, para 34.

36 Ibid, para 37.

37 Ibid, para 6.

38 Ibid, footnote 5. *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177; 73 ATC 4114; 4 ATR 75, considered the former s 7(1) of the 1936 Act, *Waterloo Pastoral Co Ltd v Federal Commissioner of Taxation* [1946] 72 CLR 262; 3 AITR 329; 8 ATD 165 and *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156; 8 ATD 75; 3 AITR 258 considered the former s 23(m) of 1936 Act, and *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1940) 64 CLR 15; 2 AITR 136; 6 ATD 42 (High Court); *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) 64 CLR 241; 2 AITR 167; 6 ATD 82 (Full High Court) considered the former s 23(n) of 1936 Act. Support for the Commissioner's view is found in Baldwin (above n 27, 171) who notes in 1937 that the definition in s 6(1) is only conclusive of residence elsewhere and residence under these provisions must be determined in accordance with the common law.

abides”³⁹ seems to support one element view, the *De Beers* case involved the question of the residence of a company under taxation laws that did not include a statutory definition of that concept;⁴⁰ and

- in *Mitchell* the company was held to be carrying on a business wholly outside the United Kingdom notwithstanding that its central management and control was in the United Kingdom.⁴¹

In light of these arguments, the Ruling concludes that for a company to be a resident under the second statutory test the two separate requirements must be met. This interpretation will give effect to all the words of the second statutory test, which is a preferable interpretation to one which makes the words “carries on business in Australia” superfluous and unnecessary.

However, despite the Commissioner’s attempt to restrict the impact of *Malaysian Shipping* to cases where the business is the management of investments, the Commissioner’s arguments struggle in light of the overwhelming weight of precedent endorsing the statements of Williams J in *Malaysian Shipping*.⁴²

39 *De Beers Consolidated Mines v Howe* [1906] AC 455, 458; (1906) 5 TC 211, 213 (Lord Loreburn LC). TR 2004/15 notes (at footnote 6) that the principle has been subsequently adopted in *Koitaki Para Rubber Estates v Federal Commissioner of Taxation* (1941) 64 CLR 241; 2 AITR 167; 6 ATD 82, *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156; 8 ATD 75; 3 AITR 258, *Unit Construction Co Ltd v Bullock* [1960] AC 351, *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177; 73 ATC 4114; (1973) 4 ATR 75, and many other cases.

40 TR 2004/15, above n 32, para 40.

41 *Ibid*, para 36.

42 See, eg, *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177; 73 ATC 4114; (1973) 4 ATR 75, *Waterloo Pastoral Co Ltd v Federal Commissioner of Taxation* [1946] 72 CLR 262; 3 AITR 329; 8 ATD 165, *North Australian Pastoral Co Ltd v Federal Commissioner of Taxation* (1946) 71 CLR 156; 8 ATD 75; 3 AITR 258, and *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) 64 CLR 241; 2 AITR 167; 6 ATD 82. In July 2000, as part of consultation on the proposed entity tax measures (see Review of Business Taxation, Parliament of Australia, *A Tax System Redesigned* (1999), sections 11, 12, 13, 16 and recommendations 6.7, 6.20, 6.21, 6.22, 6.23 and 18.6) the residency test recommended for an “entity” was a central management and control test without the carries on business element.

(c) *The first element - Carries on business test*

In light of the uncertainty about whether the “carries on business in Australia” element does have independent operation (highlighted above) and given that the “carries on business in Australia” element is also a common operational element of the voting power test, in order to avoid duplication and to ensure relevance, the scope of the words “carries on of a business” will be discussed (below at Part 2 B(4)(b)) in the context of the voting power residency test.

(d) *The second element - central management and control*

The second element of the test (central management and control) focuses on the “management and control” exercised by the directors, not the “control” of the company by shareholders through the general meeting, which is the focus of the “voting power control” test. Therefore, while the words “management” and “control” are distinct terms, in this context they are often interpreted together. The word “central” in the formulation qualifies the words “management and control” in order to indicate that the test is focused on the people who occupy the pinnacle of power, the directors, not the minor day to day managers.⁴³ This approach differs from modern corporate regulation adopted under the *Corporations Act 2001*(Cth), which acknowledges that day-to-day managers can have defacto control of a company and that this practical control can circumvent, in some circumstances, the legal control exercised by the board.

Ascertaining a company’s residence under this test is mainly a question of fact.⁴⁴ However, it is possible to distil from the cases a number of factors that will assist in determining with whom the central management and control lays. The company's

43 The importance of the word “central” was stressed as long ago as 1930 by the then Leader of the Opposition, Sir John Greig Latham, who in the House of Representatives noted that the removal of the word “central” could result in a company being “. . . held to be a resident in Australia, although there was no real and genuine control of it in the Commonwealth.” He also warned that the words could be interpreted as “whole management and control should be in Australia” which would facilitate tax avoidance (see Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4859 (Sir John Greig Latham, Opposition Leader)). Peter Gillies agrees, observing that in order to indicate that he was concerned to identify the people who occupy the pinnacle of power Lord Loreburn LC in *De Beers Consolidated Mines v Howe* [1906] AC 455 inserted the adjective “central” to his test – ‘Understanding Company Residence: Central Management and Control’ (1989) 1(4) *CCH Journal of Australian Taxation* 52, 54.

44 *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) 64 CLR 241, 246; 2 AITR 167, 170; 6 ATD 82, 85. Couzin, above n 1, 44 notes that “[w]hile the test for residence is a question of law, its application is a pure question of fact. Corporate residence is found not where central management and control should abide but where it actually does abide.”

constitution (memorandum and article of association) will normally provide that the power to control the company is vested in a board of directors.⁴⁵ However, these documents are not conclusive as the application of the test is determined “. . . not according to the construction of this or that regulation or by-law, but upon a scrutiny of the course of business and trading”.⁴⁶ Thus, a single person alone may exercise central management and control. This would occur where a chairman or managing director exercised powers conferred by the articles or the board is merely a “cypher” for a controlling shareholder as in *Malaysian Shipping*.⁴⁷

Lord Radcliffe also applied this view of constituent documents in *Unit Construction Co Ltd v Bullock*.⁴⁸ The House of Lords found in *Unit Constructions* that the central management and control of African subsidiaries of a United Kingdom parent company was being exercised by the directors of the parent company, despite constituent documents giving the power to the directors of the African subsidiaries. The facts revealed that the directors of the parent company were actually making all major and some minor decisions on behalf of the African companies. The chairman of the board of all the subsidiary boards accepted this despite no formal agreement being entered into.

It is clear from the judgement of Gibbs J in *Esquire Nominees Ltd v Federal Commissioner of Taxation*,⁴⁹ however, that “control” has to be actual control, not implied. Justice Gibbs in rejecting the Commissioner's argument (that as the trustees carried out the directions of an accounting firm in Australia that the central management and control was in Australia) held that:

[t]he firm had the power to exert influence, and perhaps strong influence, on the appellant, but that is all . . . *I do not believe that they would have acted on instruction* . . . It was in my opinion managed and controlled there, none the less because the control was exercised in a manner which accorded the wishes of the interests in Australia [emphasis added].⁵⁰

45 A replaceable rule in the Company Constitution requires that “the business of the company is to be managed by or under the direction of directors – *Corporations Act* 2001 (Cth) s 198A(1).

46 *De Beers Consolidated Mines v Howe* [1906] AC 455, 458 (Lord Loreburn LC).

47 Richard Shaddick, ‘International Tax and structures’ (Paper presented at the 1996 Taxation Institute of Australia’s Queensland Convention, Brisbane, 24-25 May 1996) 112, 116.

48 (1959) 38 TC 712, 741; [1960] AC 351, 370-1.

49 (1972) 129 CLR 177; 72 ATC 4076; 3 ATR 105.

50 *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1972) 129 CLR 177, 190-1; 72 ATC 4076; 4086; 3 ATR 105, 115.

Although Gibbs J's decision in *Esquire Nominees Ltd* was subsequently overturned by the High Court, his views on central management and control were not one of the issues subject to the appeal.⁵¹

Further, it is argued that the *Unit Constructions* and *Esquire Nominees* cases are distinguishable on their facts.⁵² In the *Unit Constructions* case the directors stood aside completely, while in *Esquire Nominees* the directors continued to meet, make decisions exercising independent discretion, and did not solely act on instruction.⁵³ Thus, control must be “actual” control.⁵⁴

In order to determine residency, it is necessary, once central management and control has been established, to ascertain where it is exercised. The location of the company's central management and control “. . . is a question of fact to be determined in light of all the relevant facts and circumstances.”⁵⁵ There are a number of factors that determine the place where central management and control is exercised.

Generally, physical locations, such as the place of incorporation and the location of the registered office, are usually not indicative of where “central management and control” is exercised. However, they may be relevant factors in the ultimate conclusion.⁵⁶

The more likely locations will be the place where the board of directors meet.⁵⁷ In fact, the RITA Consultation Paper argues that central management and control will, in practice be found where the board of directors meet as the test is focused on the persons who have the ultimate power, the directors, not the managers responsible for the day to

51 *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177; (1973) 4 ATR 75; 73 ACT 4114. Two of the four judges noted that the company had been found to be resident of Norfolk Island, another noted the issue was not in dispute and the fourth was silent on the issue – see Couzin, above n 1, 88.

52 Magney (1975), above n 26, 76.

53 The crucial determinant is that Gibbs J did “. . . not believe that they would have acted on instruction”. The *Esquire Nominee* approach has been followed in more recent cases such as *Re Little Olympian Each Ways Ltd* [1994] 4 All ER 561 and *New Zealand Forest Products Finance NV v Commissioner of Inland Revenue* (1995) 17 NZTC 12073 – see J David B Oliver, ‘Company Residence – Four Cases’ [1996] *British Tax Review* 505.

54 TR 2004/15 (above n 32, paras 19 and 20) notes that “where a parent company exercises central management and control in Australia over a subsidiary . . . the subsidiary would need to also be carrying on business in Australia for it to be a resident under the second statutory test.” Also see *BW Noble Ltd v Mitchell* (1926) 11 TC 372.

55 TR 2004/15, *ibid*, para 15.

56 Gillies, above n 43, 59.

57 *De Beers Consolidated Mines v Howe* [1906] AC 455, *The Calcutta Jute Mills Company Limited v Nicholson* (1876) 1 TC 82, and *Cesena Sulphur Co Ltd v Nicholson* (1876) 1 TC 88.

day operations.⁵⁸ Although the place of meeting may, in some circumstances, be where central management and control is found, in other situations “central management and control” is located at the place of principal business activity (as that is where the important decisions are undertaken).⁵⁹ The place of business can also determine the place where central management and control is exercised, even where the board meets away from the place of business.⁶⁰ Thus, the simplified explanation in the RITA Consultation Paper is somewhat misleading.

However, according to the Ruling the Commissioner will, as a matter of practical compliance, accept that central management and control is in Australia if the majority of the board meetings are held in Australia (ie when the majority of directors of the company meet in Australia) and will be outside Australia if the majority of the board meetings are held in a single jurisdiction outside Australia. This position is conditional upon the central management and control being exercised by a board of directors at the board meetings and that there are no circumstances to indicate the central management and control outcome is artificial or contrived.⁶¹

In summary, although in theory the central management and control test is a statutory test, by adopting a test developed by the common law the scope of the test has been defined by a long lineage of United Kingdom and Australian judicial decisions.

58 RITA Consultation Paper, above n 28, 54.

59 In *North Australian Pastoral Company Ltd v Federal Commissioner of Taxation* (1944) 71 CLR 623; 3 AITR 314; 8 ATD 121, Dixon J concluded that a pastoral company does not carry on “. . . a financial or trading business the control and management of which might be considered to depend on decisions of policy and upon the judgement and capacity of the general manager independently of the locality. It was essentially localised. There has not been a case so far in which . . . the company has been held not to reside there.” (634; 322; 129). Also see Shaddick, above n 47, who notes that “. . . the place of directors’ meeting is significant only in so far as those meetings constitute the medium through which central management and control is exercised.”

60 Similarly, in *The Waterloo Pastoral Company Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 262; 3 AITR 329; 8 ATD 165 Williams J noted that the “. . . board of the appellant had power under the articles of association to require that all important decisions should be subject to its confirmation, and it could have met regularly and exercised this control instead of leaving these decisions to Messrs Bowater and Bingle. But to exercise this control effectively it would have been necessary for the directors to visit the stations and meet there because so many of these decisions could only be made on the spot.” (267; 332; 168).

61 TR 2004/15, above n 32, paras 15-18.

4 Voting power control test

(a) Overview

The “voting power control” test is the third of the statutory residency test for companies. It appears to be based upon the views expressed by the 1920 United Kingdom *Royal Commission on The Income Tax* that even where trading operations are carried on abroad principally through a subsidiary company, the company should be deemed to be controlled in the United Kingdom:

. . . if the majority of the voting power of the company can be exercised in this country. In other words, our suggestion is that no distinction should be drawn between provable active control and complete potential control.⁶²

This view is reflected in the common law.⁶³

The voting power control test was intended to apply “. . . to companies . . . whose shareholders controlling the voting power of the company are residents of Australia” to ensure that the resident shareholders, who receive tax free dividends arising from profits not taxed outside Australia, are taxable on those dividends.⁶⁴ Thus, its focus is on shareholder control, not management control.

The test has two elements: the company must be carrying on business in Australia and its voting power must be controlled by shareholders who are residents of Australia. In applying the test, unlike the central management and control test, it is clear that the “carries on business” element of this test needs to be examined separately. The reason that the test cannot be satisfied by merely meeting the voting power control threshold is that mere underlying ownership does not equate to the carrying on of a business. Therefore the carries on business element will be examined first, followed by an examination of the voting control element.

62 United Kingdom, *Report of the Royal Commission on the Income Tax* Cmd 615 (1920), 9. This concept was adopted by United Kingdom, *Report of the Income Tax Codification Committee* Cmd 5131 (1936), in s 7 of its draft Income Tax Bill.

63 In *British American Tobacco Co v Inland Revenue Commissioners* [1943] AC 335, 339, Viscount Simon stated that owners of the majority of the voting power in the company are persons who were “in effective control of its affairs and fortunes”.

(b) *The first element – Carries on business in Australia*

There are three parts to the “carries on business” element. They are:

- the existence of a business;
- the fact it is being carried on; and
- that the activity is conducted in Australia.

These three parts are examined in the following.

(i) *Defining a business*

The first step is to determine whether the activity undertaken is a business.⁶⁵ Business is defined in s 995-1 of 1997 Act to “. . . include any profession, trade, employment, vocation or calling, but does not include occupation as an employee.” As the definition lacks detail, the common law further expands this definition. In *Grieve v Commissioner of Inland Revenue (NZ)* Richardson J stated:

In common usage 'business' has had and has long had a wide and flexible meaning. In the sense in which it is used in the legislation imposing a charge for tax in respect of revenue earning activities *The Oxford English Dictionary* definitions "a pursuit demanding time and attention; a serious employment as distinct from a pastime . . . ; trade; commercial transactions or engagements' and *Webster's Third New International Dictionary* definitions 'a usually commercial or mercantile activity customarily engaged in as a means of livelihood and typically involving some independence of judgment and power of decision . . . a commercial or industrial enterprise' reflect the underlying notion . . .⁶⁶

64 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 11.

65 Williams J in *Malayan Shipping Co v Federal Commissioner of Taxation* (1946) 71 CLR 156; 8 ATD 75, 3 AITR 258 indicated that “mere trading” would not satisfy the test. Also Hamilton, above n 15, para 2.200 question the effect of the dicta on the test, concluding that it only applies to companies engaged in trading activities.

66 [1984] NZLR 101, 106. The quote was cited with approval by Burchett J in *Federal Commissioner of Taxation v Bivona* (1989) 20 ATR 282, 290; 89 ATC 4183, 4190-1.

Whether a taxpayer is carrying on a business is a question of fact. The courts have identified the following criteria as important factors to be weighed in determining if a business exists:⁶⁷

- (a) the repetition of transactions or activities;⁶⁸
- (b) the commercial nature of the activities;⁶⁹
- (c) the size and scale of the activities;⁷⁰
- (d) the existence of a profit motive;⁷¹
- (e) organisation and system underlying the activities;⁷²
- (f) the inherent characteristics or qualities of the property dealt in;⁷³ and
- (g) the inherent characteristics of the taxpayer.⁷⁴

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- 67 Michael Kobetsky, 'Chapter 4: Business Income' in Michael Kobetsky, Michael Dirkis and Ann O'Connell, *Income Tax: Text, Materials and Essential Cases* (2001, 3rd ed) 138-139.
- 68 Although sustained, regular or frequent transactions do not in themselves signify a business, they are a useful indication of a business: *London Australian Investment v Federal Commissioner of Taxation* (1977) 138 CLR 106; 7 ATR 757; 77 ATC 4398. An isolated transaction can constitute a business: see *Fairway Estates v Federal Commissioner of Taxation* (1970) 123 CLR 153; 1 ATR 72; 70 ATC 4061, where one loan by a property development company to a mine was considered to indicate the carrying on of a business. See also *Federal Commissioner of Taxation v Whitfords Beach* (1980) 150 CLR 355; 12 ATR 692; 82 ATC 4031 and *Federal Commissioner of Taxation v Myer Emporium* (1987) 18 ATR 693; 87 ATC 4363.
- 69 The transaction must have a commercial character, ie trade on open market with all willing and suitable customers. Where it is merely preparatory to starting a business, the transaction will not have that commercial character (*Ferguson v Federal Commissioner of Taxation* (1979) 9 ATR 873; 79 ATC 4261). The length of time the property is held is relevant. The longer it is held, the less likely it is to be a business (*Eames v Stepnell Properties* (1967) 43 TC 678).
- 70 The scale of operations is a factor, but a person may carry on business in a small way (*Thomas v Federal Commissioner of Taxation* (1972) 3 ATR 165; 72 ATC 4094 and *Federal Commissioner of Taxation v Walker* (1985) 16 ATR 331; 85 ATC 4168). However, the smaller the operation the more likely it is not to be a business.
- 71 The mere realisation of an asset will not give rise to the motive. It can be inferred in certain circumstances - see *Thomas v Federal Commissioner of Taxation* (1972) 3 ATR 165; 72 ATC 4094.
- 72 Bowen CJ and Franki J in *Ferguson v Federal Commissioner of Taxation* (1979) 9 ATR 873, 887; 79 ATC 4261, 4264 stated "organisation of activities in a business-like manner, the keeping of books, records and the use of system may all serve to indicate that a business is being carried on. The fact that, concurrently with the activities in question, the taxpayer carries on the practice of a profession or another business does not preclude a finding that his additional activities constitute the carrying on of a business. The volume of his operations and the amount of capital employed by him may be significant."
- 73 Goods unsuitable for domestic use will suggest a business activity, eg pig iron (*Edwards v Barrstow* [1964] AC 14), while conversely, goods suitable for domestic use will not suggest domestic activity, eg toilet paper (*Rutledge v Inland Revenue Commissioners* (1929) 14 TC 4).
- 74 The inherent characteristics of the taxpayer were in the past, indicative of a business being carried on, eg if a company carried on an activity, it was more likely that the activity would be part of a business than if an individual carried on the activity (*Lewis Emanuel v White* (1965) 42 TC 362). Current decisions do not seem to take this view.
- However, in *Radnor Pty Ltd v Federal Commissioner of Taxation* (1990) 21 ATR 608; 90 ATC 4637, Davies J observed that "... when a taxpayer is a trustee, it is less likely that a finding will be made that the sale of shares was an operation in the course of carrying on a business of investing for profit and more likely that the finding will be made that the sale was a mere realisation or change of investment" (619-620; 4649). Although the Commissioner's appeal was dismissed in *Radnor Pty Ltd v Federal Commissioner of Taxation* (1991) 21 ATR 1410; 91 ATC 4689 the Full

The weight that is given to each of these factors varies from case to case as each case is decided in terms of questions of fact and degree.⁷⁵ In different factual situations some of these factors will carry more weight than another factor. Justice Webb in *Martin v Federal Commissioner of Taxation*⁷⁶ confirmed this stating that:

The test is both subjective and objective: it is made by regarding the nature and extent of the activities under review, as well as the purpose of the individual engaging in them, and . . . the determination is eventually based on the large or general impression gained.

However, the Ruling argues that the concept of business in the second statutory test (and presumably the third statutory test) is wider than its ordinary meaning and “extends to undertakings of a business or a commercial character.”⁷⁷ With respect, there is no reason to treat the concept of “business” as being any different than its ordinary meaning for the purposes of the definition of resident for companies. The concept of “business” will ordinarily extend to undertakings of a business or a commercial character including management of investment assets.⁷⁸

Federal Court conceded that the existence of a trustee undertaking the activity is not decisive, but it is a relevant factor.

75 *Shepherd v Federal Commissioner of Taxation* (1975) 5 ATR 646; 75 ATC 4244.

76 (1953) 90 CLR 470; 5 AITR 548, 551. Although the Full Court overturned Webb J’s decision, his view was not specifically rejected. It was subsequently endorsed by Fisher J in *Ferguson v Federal Commissioner of Taxation* (1979) 9 ATR 873, 881; 79 ATC 4261, 4268-9.

77 TR 2004/15, above n 32, para 42. The Ruling argues that “if the objects of a company are business objects and the company actually carries out these business objects, then the company is carrying on business: *IRC v Westleigh Estates* [1924] 1 KB 390, 408, 409 (Sir Ernest Pollock, MR). If a company gainfully uses its property in letting it out for rent, the inference is that the company is carrying on business (*American Leaf Blending Co Sdn Bhd v Director-General of Inland Revenue (Malaysia)* [1978] 3 All ER 1185, 1189 (Lord Diplock)) as ‘the purchase of property to rent out, whether or not after renovating it, and the proprietorship of that property, constitute an undertaking of a business or commercial kind’ - *Lilydale Pastoral Co Pty Ltd v Federal Commissioner of Taxation* (1987) 18 ATR 508; 87 ATC 4235 (Pincus J). Also see *California Copper Syndicate (Limited and Reduced) v Harris* (1904) 5 TC 159; *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 204, 221; 73 ATC 4114, 4123; 4 ATR 75, 85 (Menzies J) and (1973) 129 CLR 204, 229; 73 ATR 4114, 4128; (1973) 4 ATR 75, 91 (Stephen J) and *Federal Commissioner of Taxation v Total Holdings (Australia) Pty Ltd* (1979) 9 ATR 885; 79 ATC 4279.

78 In TR 2004/15, *ibid*, para 42. The reason for this approach seems to be that the Commissioner is unduly concerned that cases, which were decided in the context of trusts (*Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598; 6 AITR 85; 10 ATD 328, *Radnor Pty Ltd v Federal Commissioner of Taxation* (1990) 21 ATR 608; 90 ATC 4637), may have operation in respect of companies. This is reflected in the Commissioner’s alternative view (in para 45) that “the second statutory test refers to a narrow concept of carrying on of a business, such that a company that invests with the purpose of obtaining gains from that investment may not be carrying on a business.”

(ii) *Is there a business in existence being carried on?*

Having found a business, the next question is, is there a business in existence being carried on? In the Taxation Ruling TR 2004/15 the Commissioner states that in the statutory context it is assumed that all companies (other than dormant companies) are carrying on a business.⁷⁹ However, this is not supported in the case law. In *Southern Estates Pty Ltd v Federal Commissioner of Taxation* and *Softwood Pulp and Paper Ltd v Federal Commissioner of Taxation* the Courts held that in both cases the companies were not carry on a business as the activities undertaken were preliminary to commencing a business.⁸⁰

Although Brett LJ in *Smith v Anderson* Brett LJ noted that “[t]he expression ‘carrying on’ implies a repetition of acts”,⁸¹ subsequent cases have found that a single activity can constitute the “carrying on of a business”.⁸² In *United Dominions Corporation Ltd v Brian Pty Ltd* Dawson J noted that “. . . the emphasis which will be placed upon continuity may not be heavy”.⁸³

Thus, if a business is not being conducted or is no longer being conducted then the test is not satisfied.

(iii) *Is the business in Australia?*

The final aspect of the “carries on business” element to be determined is whether the location of the business is in Australia. This will normally be determined in the course of finding whether a business is being carried on. However, it may be difficult to ascertain in the circumstances where the business involves mail order and electronic commerce. These difficulties will be discussed later in the chapter.

79 TR 2004/15, *ibid*, para 45.

80 *Southern Estates Pty Ltd v Federal Commissioner of Taxation* (1966) 117 CLR 481; 10 AITR 525; 14 ATD 543; and *Softwood Pulp and Paper Ltd v Federal Commissioner of Taxation* (1976) 7 ATR 101; 76 ATC 4439.

81 (1880) 15 Ch D 247, 277-78 (Brett LJ).

82 *Smith v Anderson* (1880) 15 Ch D 247 and *Canny Gabriel Castle Jackson Advertising Pty Ltd v Volume Sales (Finance) Pty Ltd* (1974) 131 CLR 321.

83 (1985) 157 CLR 1, 15 (Dawson J).

(c) *The second element - Voting power controlled by shareholders who are residents of Australia.*

Having found that a business is being carried on in Australia, the next step is to determine the scope of the “voting power control” element. To do so, it is necessary to examine the meaning of the key words: “voting power”, “control” and “resident in Australia”.

(i) *Voting power*

The words “voting power” have not been judicially considered in the context of s 6(1)(b) of the 1936 Act. However, the words “voting power in the company” were considered by the High Court in the context of the former ss 80A(1) and 80C(1) of 1936 Act. In *Kolotex Hosiery (Australia) Pty Ltd v Federal Commissioner of Taxation*⁸⁴ Barwick CJ concluded that voting power includes not only the powers vested in the shareholders but also the voting power of an office holder exercised at the general meeting. In the current context, even if all the shareholders of a company are Australian residents, the company may still be a non-resident if a non-resident executive director controls more than half the company’s voting power.

(ii) *Control*

The word “control” has been considered a number of times.⁸⁵ The courts have found that “control” in s 6(1)(b) of the 1936 Act means the “actual” control of the voting rights, not the mere holding of those rights. It has been argued that the test looks at the exercise of the actual control, not the merely the capacity to control.⁸⁶ In other words, in order to demonstrate control of voting power, that control must have been exercised in the general meeting. Thus, the test cannot be satisfied where the controlling resident owners abstain from voting at the general meeting. Further, as the test is based upon actual control, it cannot be satisfied where controlling resident owners have beneficial

84 (1975) 132 CLR 535; 5 ATR 206; 75 ATC 4028.

85 *Adelaide Motors Ltd v Federal Commissioner of Taxation* (1942) 66 CLR 436; 2 AITR 341; 7 ATD 147; *Federal Commissioner of Taxation v Commonwealth Aluminium Corp Ltd* (1980) 143 CLR 646; 11 ATR 42; 77 ATC 4151; *West Australian Tanners and Fellmongers Ltd v Federal Commissioner of Taxation* (1945) 70 CLR 623; 3 AITR 242; 8 ATD 25.

86 Hamilton, above n 15, para 2.200 and Geoffrey Lehmann and Cynthia Coleman, *Taxation in Australia* (1998, 5th ed), para 18.160.

control, the actual control being vested in a non-resident trustee or nominee. Indirect forms of control, such as voting agreements with share holders, may also not satisfy the actual control requirement.

Thus, to satisfy the “voting power control” test, the resident shareholders must have actual control over 50 percent of the voting power. Legal capacity to control must also exist.⁸⁷ The importance of control at the general meeting, however, should not be overstated. Where a resident shareholder’s control is through the board of directors, the central management and control test is more likely to have operation, deeming residency.⁸⁸

Further, control can be exercised through indirect actual control. Justice Kitto in *Mendes v Commissioner of Probate Duties (Vic)*⁸⁹ endorsed (obiter dictum) an indirect control qualification, stating if:

... a company A, which by virtue of its voting power in a general meeting of company B controls that company, has a controlling in company C if company B holds the majority of votes in the General meeting of company C.⁹⁰

Thus, it is arguable that control can exist indirectly where a third company controlled the first company through the majority ownership of a second company that has the majority of shares in the first company.

(iii) *Resident in Australia*

The final element of the test is that the shareholders must be “resident in Australia”. This requirement is somewhat circular, merely requiring that the shareholders (trustees, companies, individuals etc) satisfy the residency rules set out in tax law.

87 *Mendes v Commissioner of Probate Duties (Vic)* (1967) 122 CLR 152 and Lehmann, *ibid*.

88 Kohl, above n 26, 449.

89 *Mendes v Commissioner of Probate Duties (Vic)* (1967) 122 CLR 152.

90 *Mendes v Commissioner of Probate Duties (Vic)* (1967) 122 CLR 152, 162. The qualification arose from the dicta of Viscount Simon in *British American Tobacco Co v Inland Revenue Commissioners* [1943] AC 335, 339-340. Also see commentary by Kohl, (above n 26, 449) and Lehmann (above n 86).

(d) Summary

In summary, in order for a company to be found resident under the voting control test the shareholders must have actual direct or indirect control of the majority of the voting power and the company must carry on business in Australia. Both elements of the test must be satisfied. However, in reality the test is of minimal significance, except in respect of tax havens, as a finding of residency under the test may often be overridden by the tie breaker tests in Australia's DTAs.⁹¹

5 Summary of Part B

Thus, the definition of residency for a company in s 6(1) of the 1936 Act (via s 995-1 of the 1997 Act) consists of the incorporation, central management and control and the voting power control tests. Unlike the incorporation test, both the central management and control test, and to a lesser extent the voting power control test, are fact and circumstance tests. Further, by adopting the common law central management and control terminology as an essential element of the central management and control test, this second statutory test has imported within its scope a large body of common law, which has been further developed through subsequent litigation. The limitations and problems associated with the scope of tests will be dealt with later in the context of the evaluation of the three tests.

C. The scope of the specific corporate residency tests

As well as the three primary residency tests in s 6(1) of the 1936 Act there are also specific "residency" definitions. They can be divided into two classes: those applying in respect of deemed companies and those that operate for specific tax policy purposes. The scope of these specific residency definitions is set out in the following, except for the rules relating to dual resident companies which are explored in the context of DTAs.

91 Kohl, *ibid.*

1 *The deemed company rules*

The first category of specific residency tests are those in respect of “corporate limited partnerships”⁹² and “resident unit trusts”⁹³ (for the purposes of “corporate unit trusts”⁹⁴ and “public trading trusts”⁹⁵), both of which are treated as companies under the tax law. The scope of these specialised rules is explored in the following.

(a) *Special rules for corporate limited partnerships*

The first deemed company specific residency definition relates to “corporate limited partnerships.” The rules relating to “corporate limited partnerships” were introduced in response to the potential negative revenue impact of losses flowing through limited partnerships. To limit the flow through of losses the Commonwealth passed provisions to treat limited partnerships as companies from 19 August 1992.⁹⁶ It was conceded they had revenue benefit but the change was advocated on the basis of an equity objective of treating like structures comparably.⁹⁷

To overcome the practical problem that limited partnerships lack legal personality the 1936 Act imposes liability on each partner and each partner is deemed to be jointly and severally liable for the amounts so charged.⁹⁸

A preliminary issue to discussing the residency rules for corporate limited partnerships under the 1997 Act is to determine what “corporate limited partnerships” are for the purposes of the 1997 Act.

92 1936 Act s 94T.

93 1936 Act s 102H, 102Q.

94 1936 Act s 102J.

95 1936 Act s 102R.

96 *Taxation Laws Amendment Act (No 6) 1992* (Cth). Limited partnerships were viewed as a tax effective vehicle for infrastructure and other large-scale investments. They were also used for film or other investments where deductions in excess of cash contributed could be available.

97 Explanatory Memorandum, *Taxation Laws Amendment Bill (No 6) 1992* (Cth), 3. This approach has been criticised – see Miranda Stewart, ‘Towards flow through taxation of limited partnerships: It’s time to repeal Division 5A’ (2003) 32 *Australian Tax Review* 171.

98 1936 Act s 94V.

(i) *What is a corporate limited partnership*

For the purposes of the income tax laws a “corporate limited partnership” is defined to be a “limited partnership.”⁹⁹

In Australia limited partnerships are a creation of State statutes. There has been limited partnership legislation in Queensland since 1876, Tasmania since 1908 and in Western Australia since 1909,¹⁰⁰ with limited liability partnership provisions being added to the partnership Acts in New South Wales in 1991,¹⁰¹ Victoria in 1992¹⁰² and South Australia in 1997.¹⁰³ Generally a limited partnership is partnership in which one or more partners’ liability is limited.¹⁰⁴ The statutes prescribe four general characteristics for registration as a limited partnership. They are that:

- one or more general partners must be liable for all debts and obligations;
- one or more limited partners who contribute capital cannot be required to provide funds in addition to the capital contribution;
- limited partner cannot draw capital during the continuance of the partnership; and
- limited partners cannot take part in the active management of the partnership.

However, a “limited partnership” for the purposes of the income tax laws is defined to be “. . . a partnership where the liability of at least one of the partners is limited”.¹⁰⁵ A general partnership will not be a limited partnership merely because one of its members

99 1936 Act s 94D. Section 94D also contains further deeming tests which bring into the operative rules limited partnership formed before 19 August 1992.

100 The Irish 1781 model limited partnership was adopted in New South Wales from 1853 to 1874 and in Queensland from 1876 to 1988 (*Mercantile Acts 1876-1896* (Qld) ss 53-68). The Queensland provisions were modernised in 1988 (*Partnership (Limited Liability) Act 1988* (Qld)). The *Limited Partnerships Act 1908* (Tas) and the *Limited Partnerships Act 1909* (WA) were based on the United Kingdoms *Limited Partnership Act 1907* (UK).

101 *Partnership Act 1892* (NSW) ss 49-80.

102 *Partnership Act 1958* (Vic) ss 49-80.

103 *Partnership Act 1891* (SA) ss 47-83.

104 They are the modern statutory equivalent of the Roman “societas” (see Terence Dwyer and Deborah Dwyer, Parliament of the Australian Capital Territory, *Australian Capital Territory Attorney-General's Department Review of ACT Partnership Law: Consultative Document* (1992), 2) and the medieval commenda (see Keith Fletcher, *Higgins and Fletcher: The Law of Partnerships in Australia and New Zealand* (2001, 8th ed) LBC Information Services, Sydney, 269). Such arrangements operated between financiers and merchants, where by the financier provided finance in return for a share of the profits. As they did not participate in the management of the business they were not liable for losses beyond their finance. They flourished in Europe but fell into disrepute in Tudor England.

105 1936 Act s 6(1).

is a company.¹⁰⁶ Expressly excluded from the definition are venture capital limited partnerships (VCLP),¹⁰⁷ Australian Fund of Funds (AFOF)¹⁰⁸ and venture capital management partnerships (VCMP)^{109 110}.

Also excluded from these provisions are foreign hybrids (foreign hybrid limited partnerships and hybrid limited companies, including United States' limited liability companies and other similar entities that are taxed on a partnership basis in their country of formation)¹¹¹ as partnerships for all purposes of the income tax law.¹¹² These entities can only be foreign hybrids if, amongst other things, they are at no time during the income year Australian residents.¹¹³

(ii) Residence test

The definition of "resident corporate limited partnership" is found in s 94T of the 1936 Act. For the purposes of the income tax law, a corporate limited partnership is a "resident", "a resident within the meaning of s 6", "a resident of Australia" and "a resident of Australia within the meaning of s 6" if and only if:

- the partnership was formed in Australia; or either:
- the partnership carries on business in Australia or
- the partnership's central management and control is in Australia.¹¹⁴

106 Michael Butler, 'Partnerships – Easier than you think?' (2004) 10 *Asia-Pacific Tax Bulletin* 287, 288.

107 As defined in 1997 Act s 118-405(2).

108 As defined in 1997 Act s 118-410(3).

109 As defined in 1936 Act s 94D(3).

110 1936 Act s 94D(2). These entities are taxed as flow through entities under 1936 Act, Div 5. The term "tax-exempt non-resident" entity is used to limit the scope of the concession. Thus, under s 118-420(2) of the 1997 Act an entity is "tax-exempt non-resident" entity if it is a foreign resident; that is a resident of Canada, France, Germany, Japan, United Kingdom, the United States or any other foreign country prescribed by the regulations and the entity's income is exempt, or effectively exempt, from taxation in the entity's country of residence.

111 As defined in 1997 Act ss 830-5, 830-10 and 830-15.

112 As defined in 1997 Act ss 830-20 to 830-40. See Taxation Determination TD 2004/31, *Income Tax: Which Country is for the Purposes of Part X of the Income Tax Assessment Act 1936 (the Act) the Country of Residence of a UK Limited Partnership (LP), a US LP, a UK Limited Liability Partnership (LLP) and a US LLP Being a Non-resident Corporate Limited Partnership Within Part III Division 5A of the Act?* for the treatment of non-resident limited partnerships prior to the introduction of 1997 Act Div 830 by *Taxation Laws Amendment Act (No 1) 2004* (Cth).

113 1997 Act ss s 830-10 (1)(d) and 830-15(1)(c).

114 1936 Act s 94T.

The words “a resident within the meaning of s 6” and “a resident of Australia within the meaning of s 6” were incorporated into the definition¹¹⁵ to align the treatment of corporate limited partnerships under the foreign tax credit, foreign loss, CFC and FIF provisions with the treatment of companies under those provisions.¹¹⁶

Thus, there are three elements to the test: formation in Australia, carries on business in Australia, or central management and control is in Australia. As limited partnerships are creatures of statute they can only be formed in states (discussed above) that provide for formation. In fact, a corporate limited partnership is deemed to be incorporated in the place where it was formed and under a law in force in that place.¹¹⁷ The two remaining tests (carries on business test and central management and control test) are fact and circumstance tests that draw upon the concepts of the second company residency test in s 6(1) of the 1936 Act. Given that the tests have been examined above in the company context it is not necessary to reexamine their scope in this context.

(b) Special rules for “corporate unit trusts” and “public trading trusts”

The second deemed company specific residency definition relates to “corporate unit trusts” and “public trading trusts”. The rules governing “corporate unit trusts” in Division 6B of the 1936 Act were introduced from 11 July 1980¹¹⁸ to discourage companies transferring income-earning assets to unit trusts to avoid the then double taxation of company profits. Division 6B treats such trusts as companies for tax purposes.¹¹⁹ Public Trading Trusts provisions in Division 6C of the 1936 Act were introduced on 19 September 1985¹²⁰ to apply similar measures to public unit trusts which operate a trade or business. It taxes these trusts as companies.¹²¹

As the rules governing “corporate unit trusts” and “public trading trusts” are similar, the law applicable to these two deemed companies will be considered together. Prior to discussing the residency rules for “corporate unit trusts” and “public trading trusts”

115 By *Taxation Laws Amendment Act (No 3) 1994* (Cth).

116 Explanatory Memorandum, *Taxation Laws Amendment Bill (No 3) 1994* (Cth), 43.

117 1936 Act s 94U.

118 *Income Tax Laws Amendment Act (No 3) 1981* (Cth).

119 1936 Act s 102L.

120 *Taxation Laws Amendment Act (No 4) 1985* (Cth).

121 1936 Act s 102T.

under the 1997 Act, a preliminary issue is to determine what is a “corporate unit trust” and “public trading trust” for the purposes of the 1997 Act.

(i) What is a “corporate unit trust” and a “public trading trust”?

A “unit trust” will be a “corporate unit trust” if it is:¹²²

- (a) a public unit trust (ie, a trust with listed units, offered to the public and held by 50 or more persons¹²³);
- (b) an eligible unit trust;¹²⁴ and
 - either (i) a ‘resident unit trust’;¹²⁵ or
 - (ii) a ‘corporate unit trust’ in a prior year.

However, a public trading trust is:¹²⁶

- (a) a public unit trust;¹²⁷
- (b) a trading trust;¹²⁸ and
 - either (i) a resident unit trust;¹²⁹ or
 - (ii) a public trading trust in a prior year which is not a corporate unit trust.

(ii) Definition of “resident unit trust”

The “resident unit trust” definitions for both “corporate unit trusts” and “public trading trusts” are identical. A unit trust will be a “resident unit trust” for an income year if, at any time during the income year either:

- any property of the trust is situated in Australia or
- the trust carries on a *business in Australia;

and either:

- the central management and control of the trust is in Australia; or
- Australian residents held more than 50% of the beneficial interests in the income or property of the trust.¹³⁰

122 1936 Act s 102J.

123 Defined in 1936 Act s 102G.

124 Defined in 1936 Act s 102F.

125 Defined in 1936 Act s 102H.

126 1936 Act s 102R.

127 Defined in 1936 Act s 102P.

128 Defined in 1936 Act s 102N.

129 Defined in 1936 Act s 102Q.

Thus, there are four possible combinations that will give rise to residency. Although property is defined widely in s 102D of the 1936 Act (to include a chose in action and “any estate, interest, right or power, whether at law or in equity, in or over property”), beneficial interests are not defined. As a related section expressly provides for tracing, it can be assumed that the interests measured in s 102D of the 1936 Act are only direct interests.¹³¹ Further, given that the carries on business test has been explored in the context of company residency under s 6(1) of the 1936 Act, as has the central management and control test, is not necessary to reexamine the scope of these rules again in this context.

2 Specific tax policy residency rules

The second category of specialised residency tests are those that relate to specific tax measures such as the FSI rules, the dividend imputation system, thin capitalisation and dual resident companies (“prescribed dual resident”¹³² and a “dual resident investment company”¹³³). The scope of these specific residency definitions is set out in the following, except for the rules relating to dual resident companies which are explored in the context of DTAs.

(a) FSI rules - “Australian entity” and “Part X Australian resident” definitions

The first area where specific residency definitions are used is in the FSI rules (ie, in Parts X (the CFC rules) and XI (the FIF rules) of the 1936 Act). The rules tax residents on an accrual basis in respect of lowly taxed or untaxed foreign income (usually passive) earned by non resident companies in which the residents hold shares. It is argued that these rules enforce the worldwide taxation of income of residents.¹³⁴

The “Part X Australian resident” definition was introduced to provide an enhanced jurisdictional basis for the operation of Part X. Part X of the 1936 Act operates by taxing Australian residents on an accrual basis on their share of certain income earned

130 Defined in 1936 Act s 102H and 102Q respectively.

131 1936 Act s 102G(9).

132 1936 Act s 6(1).

133 1936 Act s 6F.

134 Vann (1988), above n 22, ix xviii.

by controlled foreign companies. The income subject to attribution is both the company's tainted income¹³⁵ and income which is not subjected to comparable taxation.

Under Part X a company is defined to be an "Australian entity" if it is an entity (other than a partnership or trust) that is a "Part X Australian resident".¹³⁶ A "Part X Australian resident" is defined to be a resident in terms of s 6, but does not include an entity where there is a double tax agreement in force, the entity is a resident in both contracting states under the agreement and it is deemed, for the purposes of that agreement, to be resident in the foreign state.¹³⁷ The concept of "Australian entity" is crucial as only Australian entities can be attributed with foreign income,¹³⁸ and is crucial in determining the control test,¹³⁹ and the definition¹⁴⁰ of an "Australian 1% entity".¹⁴¹

Similarly, under Part XI a resident company is defined in terms of a "Part XI Australian resident". A "Part XI Australian resident" is defined to be a resident in terms of s 6, but does not include an entity where there is a double tax agreement in force, the entity is a resident in both contracting states under the agreement and it is deemed, for the purposes of that agreement, to be resident in the foreign state.¹⁴² Part XI operates by taxing Australian residents on an accrual basis on their share of certain income earned by non-resident entities that are not Australian controlled and fall outside the scope of the CFC and transferor trust measures.

Thus, if a dual resident company is a resident under the s 6(1) of 1936 but is deemed to be a non-resident under the DTA tie breaker tests, it cannot be a "Part X Australian resident" or "Part XI Australian resident". As the resident definitions in s 6(1) of 1936 Act have already been discussed and the DTA tie-breaker test is to be analysed below, further discussion of these tests would duplicate those examinations.

135 Tainted income is passive income (such as dividends, interest and royalties), and certain related party income.

136 1936 Act s 336.

137 1936 Act s 317.

138 1936 Act s 361(1).

139 1936 Act ss 340 and 349.

140 1936 Act s 317.

141 Explanatory Memorandum, Taxation Laws Amendment (Foreign Income) Bill 1990 (Cth), 223.

142 1936 Act s 470.

(b) *Imputation rules - "Residency requirement" definition*

The second area of specific residency definition is under the dividend imputation system. The rules exist to reinforce the object of the dividend imputation system, ie to allow Australian resident companies, corporate limited partnerships, corporate unit trusts, and public trading trusts to pass tax credits for income tax paid (franking credits) with profit distributions to Australian members, such that they can offset those credits against tax liabilities (a tax offset) or in some circumstances, seek a refund of any unutilised tax credit.¹⁴³ Thus, in order for a distribution to carry an associated tax credit the entity must satisfy the "residency requirement" when making a distribution.¹⁴⁴ The residency criteria are contained in the "sufficiently resident" test, which was introduced into the 1997 Act in 2002,¹⁴⁵ having been carried over from the then existing law.¹⁴⁶

The definition of "residency requirement" in s 995-1 of the 1997 Act specifies four specific rules aimed at limiting the availability of the credits to Australian entities and Australian owners. Under the first rule an entity satisfies the "residency requirement" if the entity satisfies the specific residency rules of the entity at the time of making the distribution.¹⁴⁷ The other three "residency requirement" tests are defined in relation to events that give rise to a franking credit and a franking debit,¹⁴⁸ a tax offset¹⁴⁹ and a

143 1997 Act s 200-5 and Explanatory Memorandum, New Business Tax System (Imputation) Bill 2002 (Cth), the New Business Tax System (Over-Franking Tax) Bill 2002 (Cth) and the New Business Tax System (Franking Deficit Tax) Bill 2002 (Cth), para 1.19.

144 1997 Act s 202-5(a).

145 Introduced by *New Business Tax System (Imputation) Act 2002* (Cth).

146 Explanatory Memorandum, New Business Tax System (Imputation) Bill 2002 (Cth), the New Business Tax System (Over-Franking Tax) Bill 2002 (Cth) and the New Business Tax System (Franking Deficit Tax) Bill 2002 (Cth), para 4.4. "Sufficiently resident" was defined in 1936 Act s 160APG.

147 The "residency requirement" when making a distribution for a company or corporate limited partnership is that they must be resident at the time of the event, while a corporate unit trust and a public trading trust must be resident for the income year (1997 Act s 202-20).

148 The payment of a PAYG installment or income tax will give rise to a franking credit. The amount of the franking credit is reduced if the entity does not satisfy the residency requirement for the income year in relation to which the PAYG installment or income tax is paid. Thus, where the event gives rise to a franking credit or franking debit the "residency requirement for a company or a corporate limited partnership is that they must be resident for more than one half of the year, or at all times during a year in which it exists (1997 Act s 205-25(a) and (b)). The "residency requirement" remains the same for corporate unit trusts and public trading trusts.

149 Where a tax offset is received, the "residency requirements" is the same as those for making a distribution, with the addition of a residency requirement for an individual (ie resident at time of the event) (1997 Act s 207-75). An individual or a corporate tax entity that receives a franked distribution directly must be resident at the time the distribution is paid to be eligible for a franking offset. If the taxpayer was not a resident, the distribution would be exempt from withholding tax because it is franked and therefore exempt from income tax, removing the need for a tax offset. The taxpayer's assessable income is not grossed-up in this case. In the case of indirect distributions, adjustments are made to the taxpayer's assessable income to ensure that the entity's

refund of franking credits.¹⁵⁰ Distributions from sources in a prescribed territory are expressly excluded.¹⁵¹ Each of these “residency requirement” tests varies depending upon the event.

Thus, the residency requirement definitions utilise the principal company residency rules in s 6(1) of the 1936 Act. Again no further analysis of the scope of the rules is required.

(c) Thin capitalisation rules - “Resident TC group” definition

The third area of specific residency definition is under the thin capitalisation rules. The object of the thin capitalisation rules (contained in Div 820 of the 1997 Act) is to impose limits on debt/equity ratios on both non-residents with investments in Australia and residents with out bound investments. The thin capitalisation rules apply to taxpayers on an individual basis.

However, if groups of taxpayers were required to apply the rules on an individual entity basis this could lead to inequitable results as well as greater compliance costs due to each entity being required to carry out a separate calculation. In order to limit these costs grouping is permitted for certain corporate groups. Such groups only need to undertake one calculation for determining the maximum allowable debt deduction. Section 820-500 of the 1997 Act contains the conditions that must be met to enable entities to form a group for thin capitalisation purposes (ie form a “resident TC group”). Thus, a “resident TC group” can only consist of wholly-owned resident companies, certain limited partnerships, trusts and Australian branches of foreign banks. The group members cannot be a prescribed dual resident.¹⁵²

Thus, the residency concept is linked to specialised definitions used to limit the type of entities able to group for thin capitalisation purposes.

share of the franking credit is not included in the entity's assessable income - See Explanatory Memorandum, New Business Tax System (Imputation) Bill 2002 (Cth), the New Business Tax System (Over-Franking Tax) Bill 2002 (Cth) and the New Business Tax System (Franking Deficit Tax) Bill 2002 (Cth), para 5.4.

150 For a refund of franking credits, the “residency requirement” is specified for an exempt institution, which is required to have a physical presence in Australia and pursue its objectives principally in Australia at all times during the income year (1997 Act s 207-135). This rule again restricts refunds to these entities.

151 1997 Act s 202-45(b).

3 Summary

Thus, there are two classes of specific company “residency” definitions: those applying in respect of deemed companies (“corporate limited partnerships” and “resident unit trusts”) and those that operate for specific tax policy purposes such as the FSI rules, the dividend imputation system, and thin capitalisation. These definitions either rely on the s 6(1) of the 1936 Act company residency definitions or on common concepts such as central management and control. There are some specifically related elements such as “formation”, “location of property in Australia” and “50% of beneficial interest in the income or property in Australia” and the FSI and thin capitalisation residency tests that exclude entities that are dual residents. The scope of specific dual resident company tests (“prescribed dual resident” and a “dual resident investment company”) are explored in the following examination.

D. Specific dual residency tests

As with the residency of individuals, a consequence of the operation of the statutory and specific residency tests and similar tests in other jurisdictions, a company can have more than one residence (ie dual residency).¹⁵³ As a result, either double taxation may occur¹⁵⁴ or in some cases the dual resident may double-dip. The double dipping occurs through the dual resident either accessing concessions in the domestic tax law in both jurisdictions or through obtaining deductions for a single item of expenditure in both jurisdictions.

Double taxation is dealt with through the use of tie breaker tests in DTAs. Article 4(5) of most of Australia’s modern DTAs, (except the United States and Japan DTAs) contains a tie-breaker test for entities. The approach to countering double dipping,

152 1997 Act s 820-500(4).

153 *Gregory v Deputy Commissioner of Taxation (WA)* (1937) 57 CLR 774, 778; 1 AITR 201; 4 ATD 397 and *Swedish Cental Railway Co v Thompson* [1925] AC 482. Dual resident entities should not be confused with “dual listed companies” which are entities with merged businesses, but maintain separate corporate identities in their countries of origin. Such company structures avoid many adverse tax impacts including the risk change of residency or dual residency. As at July 2002 there were only six “dual listed companies” world wide – see David Stevens and Julian Sheezel (KPMG), *Issues in Australia’s International Tax Regime - An International Comparative Review* (Business Council of Australia Information Paper, 24 July 2002).

154 The 2003 OECD Commentary on art 4, para 21 notes that it would be “rare in practice for a company, etc to be subject to tax as a resident in more than one State”. It will only be possible if one State attaches importance to the registration and the other State to the place of effective management.

however, is to restrict domestic tax concessions to dual resident entities that are found to be resident in Australia under the tie-breaker tests. The following discussion first examines the scope of the tie breaker tests under DTAs before exploring Australia's approach to limiting double dipping by dual residents.

1 *Impact of treaties*

(a) *Tie breaker tests*

As noted in Chapter 3, as each treaty comes into existence through negotiation, the language of every treaty differs.¹⁵⁵ The variation in many cases, however, is minor. This is due to the fact that all Australian treaties since 1963 have been based upon Article 4(3) of OECD Model Convention existing at that time. Thus, although the language of the tie breaker tests varies slightly, the tie breaker test in Article 4(3) of the 2003 OECD Model Convention is represented in Australian treaties. Article 4(3) states:

[w]here. . . a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.¹⁵⁶

A number of states have made reservations in respect of the test, as they prefer other tie-breaker tests (such as the place of incorporation¹⁵⁷ or place of the head, main or registered office).¹⁵⁸ Although Australia has not made a formal reservation there are two primary tests used in Australia's DTAs to determine the residency of a person other than an individual: the company's "place of effective management"¹⁵⁹ or its "place of incorporation".¹⁶⁰ The tests are used either solely or in combination.¹⁶¹

155 Chapter 3, Part II C 2 (a).

156 The OECD believes "[i]t would not be an adequate solution to attach importance to a purely formal criterion like registration" – see 2003 OECD Commentary on art 4, para 22.

157 Canada, Mexico and United States.

158 Japan, Korea and Turkey.

159 Place of effective management criterion is used in art 4(4) (unless otherwise indicated) of Australian DTAs with Argentina, Austria, Belgium, Czech Republic art 4(5), France art 3(3), Germany art 4(3), Hungary, India art 4(3), Indonesia, Ireland, Italy, Korea, Malaysia, Malta art 4(5), Mexico art 4(5), Netherlands, New Zealand, Norway, Poland, Romania, Russia, Slovak Republic, South Africa, Spain, Sri Lanka, Sweden, Switzerland art 4(3), 2003 United Kingdom and Vietnam.

160 Place of incorporation in Taipei art 4(4) and as an alternate test in Finland art 4(4), Philippines art 4(5), and Thailand art 4(5).

161 The combinations are:

Other tie-breaker tests have been used to a lesser extent. The term “place where managed and controlled” has been used as a tie breaker test in the Singapore DTA instead of “effective place of management”,¹⁶² while tests such as “the location of a company’s head office”,¹⁶³ “place of creation”,¹⁶⁴ and “place of organisation”¹⁶⁵ are used instead of, or in conjunction with, incorporation.

The 2003 revised United Kingdom DTA also has a tie-breaker test for dual listed company arrangements. Where a dual listed company is a resident of both states it is deemed to be resident in the state it is incorporated, provided it has its primary stock exchange listing in that State.¹⁶⁶

As mentioned above, no tie breaker tests exist for dual resident entities in the United States and Japanese DTAs.

(b) Defining effective management

As the term “place of effective management” is used as a tie-breaker test in 29 of Australia’s DTAs it is important to determine its scope. The “place of effective management” test in the DTA context applies to companies and other bodies of persons, irrespective of whether they are or not legal persons, provided they are treated as a body corporate for tax purposes.¹⁶⁷

-
- the state of incorporation or otherwise constituted; if not incorporated or otherwise constituted in either jurisdiction then place of effective management (Canada art 4(4), Fiji art 4(5), and Kiribati art 4(4)); and
 - for companies – central management and control, if central management and control not in either place of incorporation (Papua New Guinea Art a(4)).

¹⁶² Singapore art 3(3)).

¹⁶³ China art 4(4) uses the place of effective management or head office. Where place of effective management in one state, head office in other, head office takes precedence.

¹⁶⁴ Place of creation is used as an alternative test in Finland art 4(4), Philippines art 4(5), and Thailand art 4(5), but as a sole test in Denmark art 4(4).

¹⁶⁵ Place of organisation is used as an alternative test in the Finland art 4(4), Philippines art 4(5), and Thailand art 4(5)).

¹⁶⁶ 2003 United Kingdom art 4(5).

¹⁶⁷ 2003 OECD Commentary on art 3, para 2. A similar test (ie “effective management of an enterprise”) is used for source allocation rules in connection with the taxation of income from shipping, inland waterways transport and air transport in art 8 of the OECD Convention, and in arts 13(3), 15(3) and 22(3). It is argued that test is subtly different as a enterprise can exist in a number of places while the place of effective management exists in only one place – see J David B Oliver (JDBO), ‘Current Notes: Effective Management’ [2001] *British Tax Review* 289, 291.

Despite the widespread use of the test and its importance to treaties it has only been subjected to limited formal review.¹⁶⁸ In *Trustees of Wensleydale's Settlement v Commissioner for Inland Revenue* the Special Commissioner noted that the place of effective management is the centre of top management, “[t]he place . . . where the shots are called, to adopt a vivid transatlantic colloquialism”.¹⁶⁹ It is the place where management directives are given, not where they take effect.¹⁷⁰

The OECD defines the place of effective management to ordinarily be the place where the key management and commercial decisions are determined, ie the place where the most senior person or group of persons (eg, the board of directors) makes decisions.¹⁷¹ Although the term is similar to the United Kingdom’s concept of “central management and control”,¹⁷² it is subtly different as effective management can only exist in one place.¹⁷³ Thus, the “place of effective management” test is “. . . a factual test based on the situs of management.”¹⁷⁴

(c) *Summary*

Thus, Australia in its residency tie-breaker tests in its DTAs uses two key tests, either solely or in combination: the place of effective management test or the place of incorporation test.

168 In fact in *Trustees of Wensleydale's Settlement v Commissioner for Inland Revenue* (1996) SpC 73; [1996] STC (SCD) 241 the Special Commissioner noted that there were no reported decisions in which the term had been considered - see JDBO (1996), above n 53, 528. However, Vogel argues that the case law in relation to the term “place of management” (*Ort der Geschäftsleitung*) in *Abgabenordnung* § 10 (the German Fiscal Code), which refers to the centre of top management, is useful in determining the scope of the test - see Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed, 1997), 262.

169 *Trustees of Wensleydale's Settlement v Commissioner for Inland Revenue* (1996) SpC 73, 78 and 79; [1996] STC (SCD) 241, 250b and 250j - cited in JDBO (1996), *ibid*, 529.

170 Vogel, above n 168. This approach is consistent with the concept of corporate control under the *Corporations Law 2001* (Cth). In contrast, until 29 April 2000 New Zealand's reported interpretation of the term “effective management” was practical day to day management, irrespective of where the overriding control is exercised.

171 2003 OECD Commentary on art 4, para 24.

172 The OECD in fact suggests the words “central management and control” can offer guidance in determining the meaning of “place of effective management” - see OECD, *Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule: Discussion Draft* (February 2001). Also see Hamilton, above n 15, para 6.140, and Tom W Magney *Australia's Double Tax Agreements: A Critical Appraisal of Key Issues* (1994), 12.

173 Philip Owen, ‘Can effective management be distinguished from central management and control?’ [2003] *British Tax Review* 296, 305 and 2003 OECD Commentary on art 4, para 24. However, it is substantially similar - JDBO (2001), above n 167, 203

174 JDBO (2001), *ibid*, 290 and 2003 OECD Commentary on art 4, *ibid*.

2 Special domestic rules for dual resident companies and deemed companies

As a consequence of the operation of the DTA tie breaker test a company can be deemed to be resident of another contracting state (and taxable in that state) while still being resident under Australia's domestic law and taking advantage of its resident status to access specific tax concessions (double dipping).¹⁷⁵ As mentioned above, to counter this risk the tax law contains special concession limiting rules that apply to dual residents. The following discussion explores the scope of these anti-avoidance rules: that is, the two specific definitions of dual residents, a "prescribed dual resident" and "dual resident investment company."

(a) "Dual resident investment company" test

The "dual resident investment company" definition, which is found in s 6F of the 1936 Act (and incorporated in the 1997 Act via s 995-1), was introduced in 1990.¹⁷⁶ It was specifically inserted as part of measures aimed at denying dual resident investment companies (usually a group financing vehicle) the ability to transfer its income and net capital losses to Australian group members,¹⁷⁷ thereby stopping "double dipping" in Australian losses and foreign losses being offset against domestic gains or income.

Section 6F defines a "dual resident investment company" in a year of income to be an Australian resident company (other than in the capacity of a trustee) which is liable to tax in a foreign country in respect of some or all of the income or profits because:

- the company was either treated as a resident or domiciled in that country under its domestic law or its management and control is treated as being located in that country for the purposes of the relevant law of that country; and
- the company was either not carrying on business with a reasonable view to profit or a substantial purpose of the company was to directly or indirectly acquire or hold shares, securities or other investments in related companies.

175 The savings of the "prescribed dual resident" measures was estimated at \$50 to \$100 million per year - Explanatory Memorandum, Taxation Laws Amendment Bill (No2) 1997 (Cth), 3. Further changes to deny intercorporate dividend rebate in respect of unfranked dividends paid to by a dual resident company and to deny dual resident companies a deduction, which offsets the effect of removal of the rebate, allowed from 1 July 2000 for certain non-resident owned companies were introduced on 14 March 2002 in *Taxation Laws Amendment Act (No 2) 2002* (Cth).

176 Introduced by *Taxation Laws Amendment Act 1990* (Cth).

(b) *“Prescribed dual resident” test*

The “prescribed dual resident” test is in s 6(1) of the 1936 Act (and incorporated in the 1997 Act via s 995-1).¹⁷⁸ A “prescribed dual resident” in a year of income is either a non-resident company deemed to be an Australian resident under the “central management and control” test or a so-called “DTA dual resident company”. A “DTA dual resident company” is an Australian resident under s 6(1) of the 1936 Act, which is deemed by the DTA tie breaker test to be resident in another country. The definition includes companies and deemed companies (corporate limited partnerships, corporate unit trusts and public trading trusts¹⁷⁹). The term “central management and control” used in this context is the common law concept.¹⁸⁰

Again the test was inserted to deny such dual residents, who are not fully subject to Australian tax, entitlement to domestic tax benefits such as dividend rebates, capital gains rollover relief, and the transfer of capital and revenue losses, making them subject to the thin capitalisation and debt equity rules and restricting dual residents access to deductions arising from accrued liabilities on securities held by offshore associates.¹⁸¹

(c) *Summary*

In summary, the dual resident definitions, being part of anti avoidance measures, do limit the scope of the residency definition.

E. Summing up the scope of the residency tests for companies

The definition of residency for a company in the 1997 Act (s 6(1) of the 1936 Act via s 995-1) consists of the incorporation test and two fact and circumstance tests. As a result of the fact and circumstance nature of these rules, a large body of common law has been adopted through the use of common terminology and further developed

177 Explanatory Memorandum, Taxation Laws Amendment Bill 1990 (Cth), 17-18.

178 Introduced by *Taxation Laws Amendment Act (No 2) 1997* (Cth).

179 1936 Act ss 94J, 102L(2) and 102T(2) respectively.

180 The words are intended “. . . to cover high level (as opposed to day-to-day) management and control” - Explanatory Memorandum, Taxation Laws Amendment Bill (No 2) 1997 (Cth), 33.

181 Michael Morley, ‘International Taxation Measures in the 1996-1997 Budget’ (1996) 25 *Australian Tax Review* 202, 204.

through litigation. Added to this matrix are a number of specific residency definitions, which in the main, incorporate many of the same or similar terminology.

Having reviewed the scope of the residency rules applying to companies, the next step is to explore the main thesis, ie “are the rules equitable, efficient, and simple” and “do the rules prevent tax avoidance”?

III. Evaluating the effectiveness of the residency rules for companies

The purpose of this Part is to explore whether these rules fail, in their practical application, to satisfy the “essential objectives” of equity, efficiency, simplicity and the prevention of tax avoidance. As discussed in Chapter 2, the evaluation will be undertaken by illustrating circumstances where the law struggles to satisfy each of the evaluative criteria. The evaluative criteria are addressed in the following order: equity; efficiency; simplicity; and the prevention of tax avoidance.

Also as indicated previously, where some examples illustrate that a number of the evaluative criteria are not satisfied, to avoid duplication in text and analysis, it is proposed to discuss them in the context of the more relevant evaluative criteria only, with a passing reference being made to the other shortcomings.

A. Equity

Consistent with the definition in Chapter 2, in determining compliance with the equity objective, the following discussion will highlight where companies in similar circumstances are not being taxed similarly (horizontal inequity). Vertical inequity, that is, the tax burdens does not fall upon those with the greatest ability to pay, does not arise in this context. The approach to be adopted is to examine the residency rules more broadly, before focusing on specific equity issues in relation to the DTA tiebreaker tests.

1 *“Facts and circumstance” tests (the “central management and control”, voting power control, and the specific residency tests)*

Under the “central management and control”, voting power control, and the specific residency tests (through the utilisation of the s 6(1) “central management and control”

and “voting power control” tests) a company (or deemed company) must determine, in light of its factual circumstances, where central management and control lies, whether a business is being carried on in Australia, or whether beneficial control by shareholders exists.

Thus, in common with other factual tests, a finding of residency could turn on a minor variation in circumstances or, hypothetically, even on a difference in a single fact. For example, a company with two Australian resident directors and one non-resident director could change its residency merely through one of the Australian directors becoming non-resident resulting the central management and control shifting off shore.

Given that minor variations in a company’s circumstances may determine residency it is possible that companies in similar circumstances could have different residency status. As horizontal equity is found where companies in similar circumstances are taxed similarly, the individual factual nature of these tests means that in application they fail to deliver horizontal equity.

2 Problems caused by interrelationship of DTAs

As discussed in Chapter 3, the primary circumstance where horizontal inequity occurs relates to the fact that DTAs only provide relief to companies covered by the bilateral agreement. Thus, where a dual resident taxpayer’s second country of residence is a country which does not have a DTA with Australia, then that company can be subjected to double taxation, while single taxation will apply to a company whose second country of residence is in a country with a DTA. As a result some dual resident companies in a DTA country will be treated differently to those dual resident companies from non-DTA countries.

Horizontal inequity can also arise where a company is treated as a resident for tax under the domestic law of each contracting state to the DTA, but the place of effective management is in a third state. In these circumstances the company will not be granted double taxation relief under the DTA, resulting in the company being more heavily taxed.

Both of these scenarios are a natural consequence of the DTA process as the inequity only arises from obtaining equity for other taxpayers covered by DTAs. Further, as mentioned previously, this inequity should be reduced in the short term as the Government in 2003 agreed to escalate Australia's future treaty negotiation program.¹⁸²

3 Summary

From the above discussion, it is evident that the residency tests for companies fail the horizontal equity evaluative criterion (ie companies in *similar circumstances* are not being taxed similarly). The rules fail to deliver horizontal equity as the:

- facts and circumstances tests can result in persons in similar circumstances having different residency status; and
- dual resident companies covered by a DTA are treated differently to dual resident companies who are not covered by a DTA.

B. Efficiency (Neutrality)

In light of the discussion in Chapter 2, the efficiency (neutrality) objective is satisfied if the rules relating to residency of companies give rise to distortions such as a taxpayer being taxed differently due to the market in which the taxpayer operates (eg physical or electronic) or if distortions arise from tax avoidance. As with the residency rules for individuals, the residency rules for companies apply the same tests to companies regardless of their mode of conducting business. However, as discussed in Part III D, these rules are able to be manipulated to minimise or avoid tax. Therefore, there is a lack of neutrality as a result of the distortion caused by or flowing from tax avoidance. Thus, they are not efficient as distortions arise from tax avoidance through manipulation of the rules.

C Simplicity

In determining whether the residency rules for companies meet the simplicity objective, the following discussion will highlight the extent to which the residency rules in

182 Treasurer 'Review of International Taxation Arrangements' (Press Release No 32, 13 May 2003), Attachment E.

application do not satisfy the indicators of simplicity. In other words it will evaluate if the rules are predictable, proportional, consistent, do not impose high compliance burdens, easy to administer, co-ordinated with other tax rules, and clear.

As mentioned in Chapter 3, as a number of these elements overlap, a single rule may be found to satisfy a number of the individual elements of the simplicity objective. Thus, the following discussion will seek to address the problems arising under the most relevant evaluative element. The extent to which these elements exist will determine the extent to which the rules will be considered to have failed the simplicity objective in that circumstance. The evaluation will follow the order of evaluative elements as set out above, but will only address those elements that are relevant.

1 Predictability

The first element for judging simplicity is to determine whether in applying the residency rules for companies, the results are predictable (ie, it is easy to understand a rule's intended and actual scope).

The principal factor that influences predictability of the residency rules for companies is that a company's residency depends upon its individual factual circumstances. As mentioned above, in considering the equity evaluative criterion under the central management and control test and the voting power control test in s 6(1) of the 1936 Act and by the adoption of these tests in the specific residency tests, a company must determine, in light of its individual circumstances, whether it has "central management and control" in Australia, "carries on business in Australia", "voting power", "control", "formation", "location of property in Australia" and has "50% of beneficial interest in the income or property in Australia".

Despite the wide spread usage of the "place of effective management" tie breaker test, the OECD notes that there is little guidance in the OECD Commentary on what constitutes "the place of effective management".¹⁸³ The lack of definitional certainty has raised questions about the effectiveness of the "place of effective management" test in the environment of advanced communications (such as videoconferencing or electronic

183 OECD Place of Effective Management Discussion Draft (2001), above n 172.

discussion group applications¹⁸⁴), dual listings and mobility of companies.¹⁸⁵ Where a remote meeting occurs, a place of management might be regarded as existing in each jurisdiction where a manager is located at the time decisions are made or where the board meets from time to time, but it may be difficult (if not impossible) to point to a particular location as being the one place of effective management. Thus, a company may have a mobile place of effective management.

On balance, as the outcome under the residency tests and the DTA tie breaker tests can turn on a single fact, the outcome in many circumstances is difficult to predict.

2 Proportional

The second element for judging simplicity is to determine whether the complexity of the residency rules is proportional to the complexity of the policy. If the law is more complex than the policy, then the law will fail this element of the simplicity criterion.

The policy underlying the residency rules, as articulated previously, is conceptually simple. For example, the broad purpose of the s 6(1) “central management and control” test is to ensure that a “. . . number of companies incorporated outside Australia whose sole or principal business is located in Australia” were taxable as residents.¹⁸⁶ Similarly, the purpose of the “voting power control” test is to ensure that “. . . companies . . . whose shareholders controlling the voting power of the company are residents of Australia”.¹⁸⁷

184 OECD Place of Effective Management Discussion Draft (2001), *ibid*, 8, 9. The OECD notes that “[t]he availability of advanced and evolving communications technology such as videoconferencing or electronic discussion group applications via the Internet means that it is no longer necessary for a group of persons to be physically located or meet in one place to hold discussions and make decisions. In a modern environment, application of the traditional approach can produce results which do not reflect the intention of the tie-breaker rule . . . Increasing numbers of enterprises conducting transnational businesses, combined with rapid improvement in global transportation systems, are also likely to have an impact on the place of effective management concept.”

185 OECD, Place of Effective Management Discussion Draft (2001), *ibid*, paras 35-45; Ward, David A, et al, ‘A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on *Crown Forest Industries*’ (1996) 44 *Canadian Tax Journal* 408, 423 and OECD, *International Tax Avoidance and Evasion: Four Related Studies* (1987) para 35.

186 Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 11.

187 *Ibid*.

However, despite these fairly simple policy objectives the facts and circumstances approach adopted in the central management and control test, and to a lesser extent in the voting power control tests makes these rules more complex in application than the simple underlying policy. Thus, complexity arising from the fact and circumstances approach adopted in the tests is disproportional in general to the underlying policy and in these circumstances fails this element of the simplicity criterion.

The use of specialist definitions, which in turn may have simple policy intents, can also complicate the law. For example, although the “Part X Australian resident” and “Part XI Australian resident” definitions operate within specific provisions, they can lead to anomalies in application of the law. Thus, a company may be deemed to be a resident for CFC purposes, but not for the general purposes of the tax law. Similarly, the definition of resident corporate limited partnership in s 94T of the 1936 Act had to be modified¹⁸⁸ two years after introduction in order to align the treatment of corporate limited partnerships under the foreign tax credit, foreign loss, CFC and FIF provisions with the treatment of companies under those provisions.¹⁸⁹

Thus, complexity arising from the use of specific tests is often disproportional in general to the policy underlying their introduction and in these circumstances fails this element of the simplicity criterion.

3 Compliance burdens

The third element used for judging simplicity of the company residency tests is to determine qualitatively the level of cost (the burden) imposed upon the company in complying with the law. If examples indicate that the compliance costs are high, the rules fail this element of simplicity criterion.

As noted above, a company, in a self assessment environment must determine, in light of its individual factual circumstances, whether it is a resident under the various tests contained in the 1936 Act. However, this process is complicated as the origins of the non-incorporation tests lie in the common law and their scope has been defined by a long line of often conflicting United Kingdom and Australian judicial decisions. Added

188 Amended by *Taxation Laws Amendment Act (No 3) 1994* (Cth).

189 Explanatory Memorandum, *Taxation Laws Amendment Bill (No 3) 1994* (Cth), 43.

to this a number of specific residency definitions (ie “corporate limited partnerships”, “resident unit trusts”, the foreign source income rules, the dividend imputation system and dual resident companies) and the impact of DTAs, a complex matrix of imprecise and often subtly different rules emerge. The uncertainty is magnified with factual application and technology changes that allow remote management.

Thus, the determination of residency is an expensive exercise as under the non-incorporation tests of residence in s 6(1) of the 1936 Act, offshore subsidiaries of Australian companies, multinationals, regional holding companies and dual listed companies can be treated as resident companies. The 2002 RITA consultation paper notes this cost and the costs associated in avoiding the application of the rules. The paper suggests that this planning can be costly and inconvenient and is unnecessary on policy grounds.¹⁹⁰

In summary, the requirement in most of the residency tests to determine a company’s residency status by its facts and circumstances is a major contributor to compliance costs for affected companies.

4 Difficulty in administration

The fourth element for judging simplicity is to determine whether there are any administrative difficulties in applying the residency rules for companies. If the rules are difficult to administer then the rules will fail this element of the simplicity criterion.

There are administrative difficulties arising from the fact and circumstance basis of the central management and control test. As a company’s residency depends upon its circumstances, the ATO is required to make individual, subjective determinations in respect of issues such as whether the company has the requisite “central management and control”. This uncertainty and the case by case nature of the test mean that the ATO is unable to give simple broad pronouncements on how the law operates. As the self assessment system is dependent on taxpayers having the necessary information to determine their tax position, the inability to provide that information impacts adversely on the ability to self assess and the extent to which the ATO can treat as reliable self-

190 RITA Consultation Paper, above n 28, 53.

assessed residency determinations.¹⁹¹ If reliability is low, risk is high and the ATO under its compliance model is required to devote additional resources to areas of risk.¹⁹² Thus, it is obvious that the uncertain and subjective “central management and control” test would have difficulty satisfying the simplicity criterion.

Similarly, the fact and circumstance basis of the “voting power control” test also makes administration difficult. Under the test, the ATO is required to make individual, subjective determinations in respect of issues such as whether the company “carries on business”, the location of the business, or whether the shareholders have the requisite “control”. This difficulty is compounded where the trading activities are conducted by mail order or electronic means (Internet). As a result it is impossible for the ATO to give simple broad pronouncements on how the law operates and it is equally difficult for taxpayers to determine their residency status. Again, this test becomes impossible to effectively administer in the self-assessment environment. It too obviously fails the simplicity criterion.

However, on the surface the “incorporation” test satisfies the criteria of simplicity and certainty, and is easy to administer. In fact the United States Department of Treasury sees that in light of the growth in Internet commerce that this test will assume greater importance.¹⁹³ The Department of Treasury notes that “[i]n the world of cyberspace, it is often difficult, if not impossible, to apply traditional source concepts to link an item of income with a specified geographic location”.¹⁹⁴

Arnold and McIntyre argue that “[t]he place-of-incorporation test provides simplicity and certainty to the government and the taxpayer.”¹⁹⁵ Similarly, the RITA Consultation Paper recognised that the test is simple for tax administrators and would lower compliance costs.¹⁹⁶ These reasons were relied upon by the Board of Taxation in

191 A search of the word “resident” on the ATOIDs section of the ATO website (URL at <http://www.ato.gov.au> located on 28 April 2004) reveals that only 19 of the over 500 ATOIDs issued between 2002 and 2004 related to companies and only one ATOID rules on a company’s residency.

192 Australian Taxation Office, Commonwealth, *Compliance Plan 2004-05* (2004).

193 Department of the Treasury (US), Office of Tax Policy, *Selected Tax Policy Implications of Global Electronic Commerce* (1996), para 7.1.5 at URL: <http://www.fedworld.gov/tel/internet.txt> as at 31 December 2003. Jinyan Li, ‘E-commerce Policy in Australia, Canada and the United States’ (2000) 6 *University of New South Wales Law Journal* 40, 42 suggests that this view maybe based upon the fact that the United States is the largest exporter in e-commerce.

194 Department of the Treasury (US), *ibid*.

195 Brian Arnold and Michael McIntyre, *International Tax Primer* (1995) 22.

196 RITA Consultation Paper, above n 28, 54.

recommending that the basis for residency of a company should be on whether it is incorporated in Australia.¹⁹⁷ Thus, the incorporation test does not impose high administrative costs.

In summary, although the incorporation test is easy to administer, the requirement in non-incorporation residency tests to determine a company's residency status via its factual circumstances remains a major contributor to tax administration difficulties for the Commissioner.

5 Co-ordinated with other tax rules

The fifth element for judging simplicity is to determine whether residency rules for companies are co-ordinated with other tax rules. If the law operates independently of other tax rules, the rules will fail this element of simplicity.

The main area of divergence is the variations in the form of residency tests in each DTA, resulting from a failure to adopt the OECD model residency article. As discussed in Part II D 1 (a), the term "place where managed and controlled" has been used as a tie breaker in the Singapore DTA instead of "effective place of management", while tests such as "the location of a company's head office", "place of creation", and "place of organisation" are used instead of in place of, or in conjunction with, incorporation. Although these differences may have arisen due to the preferences of negotiating countries, the adoption of such variations also tend to slow the DTA negotiation/renegotiation process. As a result such arbitrary departures tend to counter the simplicity objective.

In summary, the DTA rules diverge from the terms adopted in the OECD model. This divergence is a further erosion of simplicity.

6 Clarity

The final element for judging simplicity is to determine whether the law is expressed clearly. If the law is expressed unclearly, it will fail this element of simplicity.

¹⁹⁷ Board of Taxation RITA Report, above n 29, 106-9 - Recommendation 3.12.

A lack of clarity arises where a taxpayer is resident for only part of the year. This occurs where a non-resident company becomes a resident or a foreign incorporated company becomes a non-resident due to changes in its ownership or movements in its central management and control. Although there has been a view that once a company was resident it was assessable on all its income earned during the income year, including income earned prior to residency¹⁹⁸ the Federal Court in *BHP-Utah Coal Limited v Federal Commissioner of Taxation* found that a company which “. . . comes to Australia during a part of a year of income is not subject to tax in Australia on the earnings derived from sources out of Australia whilst he was a non-resident.”¹⁹⁹

Further, it is argued that the concept “sufficiently resident” for companies under imputation rules reinforces the conclusion that part year residency is possible under any of the residency tests.²⁰⁰ However, on the plain operation of the “sufficiently resident” concept this seems to do the opposite, denying the existence of a franking credit and/or a franking debit unless a company is “sufficiently resident”.²⁰¹ Further, where provisions (such as the former ss 128S and 128T of the 1936 Act) do not specifically provide for apportionment then no apportionment lies.²⁰² Thus, in certain circumstances inequity can arise where part year residency occurs. Thus, without clear start and end dates for residency, the company residency test also fails the simplicity (certainty) criterion.

7 Summary

From the discussion above, the company residency rules fail the elements that gauge simplicity. Specifically, as the outcome under the central management and control, the voting power control and the DTA tie breaker tests can turn on a single fact (the facts and circumstances), the outcome in many circumstances is not predictable. The complexity arising from the facts and circumstances approach is disproportional in general to the underlying policy, is a major contributor to compliance costs for affected companies and remains a major contributor to tax administration difficulties for the

198 *BHP-Utah Coal Limited v Federal Commissioner of Taxation* (1992) 23 ATR 258, 262; 92 ATC 4266, 4269 (Davies J) referring to the theoretical basis for the view expressed in 11 CTBR[OS] Case 78. However, it was recognised in July 2000, in the context of consultation with Treasury in respect of entity taxation, that there was a need to ensure that the law was clear that entities can be resident for part only of an income year.

199 Ibid.

200 Hamilton, above n 15, para 2.150.

201 1997 Act s 205-25(a) and (b).

202 *BHP-Utah Coal Limited v Federal Commissioner of Taxation* (1992) 23 ATR 258; 92 ATC 4266.

Commissioner. Further, the tie-breaker residency rules for companies diverge from terms adopted in the OECD model creating inconsistency and a lack of clarity exists in respect of part year residence.

In conclusion, most of the residency rules relating to companies fail the elements that gauge simplicity (ie they are not predictable, not proportional, are associated with the imposition of high compliance burdens, are difficult to administer, are not co-ordinated with other tax rules and are expressed unclearly).

D. Tax Avoidance

In determining compliance with the prevention of tax avoidance objective, the following discussion will identify the circumstances where in the application of the law there appear to be evasion or avoidance opportunities. It will first explore weaknesses in the three company residency tests in s 6(1) of the 1936 Act, before examining the DTA tie breaker test and the specific dual residency definitions.

1 Incorporation test

The incorporation test in s 6(1) of the 1936 fails to satisfy the specific criterion of prevention of tax avoidance, as it is easy to evade. Lord Loreburn LC *De Beers Consolidated Mines v Howe* in 1906, in finding that incorporation was not an appropriate test for company residence, noted that if incorporation was used, a company:

. . . might have its chief seat of management and its centre of trading in England, under the protection of English law, and yet escape the appropriate taxation by the simple expedient of being registered abroad . . .²⁰³

This concern was echoed in the debates in the House of Representatives when the Australian residency definitions were first introduced in 1930.²⁰⁴ The then Leader of the Opposition Sir John Greig Latham noted “. . . that large companies which have the prospects of extending their operation beyond Australia will be driven to incorporate themselves outside Australia.”²⁰⁵

203 *De Beers Consolidated Mines v Howe* (1906) 5 TC 198, 213 (Lord Loreburn LC)

204 Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4859 (Sir John Greig Latham, Opposition Leader).

205 Ibid. Also see Hamilton, above n 15, para 2.180, Vann (1995), above n 16, 6 and Li, above n 193.

When the prevalence of on-line offshore incorporations²⁰⁶ is combined with inexpensive incorporation in tax havens it is clear that the incorporation test is highly vulnerable to manipulation.²⁰⁷ This vulnerability to manipulation flows from the test's reliance on form. It is argued that the visible attributes (the physical presence) of the company in the form of permanent establishments and subsidiaries are "dissolving in cyberspace", particularly where the company offers services totally on line such as software, news, recorded music, art, electronic books, gambling and travel.²⁰⁸ Thus, it is argued that companies through an incorporation test can choose to pay tax on a source or residence basis.

However, despite these problems Arnold and McIntyre argue that "...the place-of-incorporation test places some limits on the ability of corporations to shift their country of residence for tax avoidance purposes" since "[i]n general, a corporation cannot freely change its place of incorporation without triggering a tax on the accrued gains in respect of its property."²⁰⁹

Similarly, the RITA Consultation Paper²¹⁰ identified that some features of Australia's tax system would reduce the risk to Australia of relying on place of incorporation as the sole test of residency. The RITA Consultation Paper identified the dividend imputation system, which is only available to resident companies and Australia's taxation of the foreign source income of resident companies, which is arguably less aggressive than the United States. As in the United States, changing residence could also trigger CGT liabilities for the company as well as for shareholders.

However, the RITA Consultation Paper noted that there is a trend in the United States to minimise their United States' company tax by changing the location of the parent company (without any substantive changes in their operations) and the use of start up

206 Kohl, above n 26, 443.

207 Li, above n 193, 41. Also see Bjorn Westberg, *Cross-boarder Taxation of E-Commerce* (2002), 36.

208 Kohl, above n 26, 444. However, the ATO has not found this to be the case - see Australian Taxation Office, Commonwealth, *Taxation and the Internet: Second Report* (1999) (ATO's second Internet Report) and John Davidson, 'ATO Figuring the Best Way to Tax the Web' *Australian Financial Review* (Sydney), 11-12 December 1999, 20.

209 Arnold, above n 195, 22.

210 RITA Consultation paper, above n 28, 54-5.

companies in tax havens. The RITA Consultation Paper concludes that the United States experience still justifies caution in adopting an incorporation only test.²¹¹

Many submissions to the Board of Taxation on the issue argue that the existence of Australia's tax rules (eg the dividend imputation requirements, capital gains tax on any disposal, transfer pricing rules, CFC rules and the thin capitalisation laws) reduce the risk of "corporate inversions".²¹² This view was accepted by the Board of Taxation, which recommended that the basis for residency of a company should be on whether it is incorporated in Australia.²¹³ Despite this recommendation, the Government deferred consideration of changes to the domestic tests of company residence pending the release of a Taxation Ruling by the ATO to clarify its view on the operation of the current tests.²¹⁴

2 Central management and control test

The "central management and control" test also fails to satisfy the anti avoidance criterion. Concerns about the effectiveness of the test were also raised as early as 1930 when the residency definitions were first introduced.²¹⁵ The then Leader of the Opposition, Sir John Greig Latham, in the House of Representatives noted that the central management and control test would be avoided by ". . . encouraging companies to remove their central management and control from Australia and arrange to be controlled by persons abroad."²¹⁶ The place of management style test is easily exploited "because a change in the place of management generally can be accomplished without triggering any tax".²¹⁷

In its first report on the Internet, however, the ATO concludes that there is sufficient authority to indicate that the courts are open to modifying the application of the "central management and control" test to the electronic communication environment (eg

211 Ibid 55 - Option 3.12.

212 For example the Institute of Chartered Accountants in Australia, *Review of International Taxation Arrangements - Submission to the Board of Taxation on the Commonwealth Department of Treasury's Consultation Paper of August 2002*, 31 October 2002, 33 and Business Council of Australia and the Corporate Tax Association, *Joint Submission to the Board of Taxation - Review of International Taxation Arrangements*, 12 November 2002, 73-4.

213 Board of Taxation RITA Report, above n 29, 106-9 - Recommendation 3.12.

214 Treasurer "Review of International Taxation Arrangements" (Press Release No 32, 13 May 2003).

215 Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4859 (Sir John Greig Latham, Opposition Leader).

216 Ibid.

Internet, videoconferences, etc).²¹⁸ Despite this optimistic view the ATO concedes that applying a factual test will prove difficult.²¹⁹

This is not a new problem as in the past the courts have struggled to determine the place of management and control where directors live in different parts of the world.²²⁰ Although, it is now accepted that dual residency can exist where central management and control of a company is divided,²²¹ it will be often difficult to establish this on the facts.²²²

This problem is compounded by the instantaneous and global facilities, available currently, which render physical meeting otiose.²²³ The *Corporations Act* permits directors' meetings to use any technology consented to by all the directors, but there must be some evidence of participation by the directors.²²⁴ Even where physical meetings take place, its location may be determined by taxpayer manipulation.²²⁵ This view is confirmed by the Business Council of Australia who noted the:

217 Arnold, above n 195, 23.

218 Australian Taxation Office, Commonwealth, *Tax and the Internet: Discussion Report* (1997) para 7.2.20 (ATO's first Internet Report).

219 Ibid para 7.2.21.

220 Kohl, above n 26, 446. The slow acceptance of the "dual residence" concept is highlighted by comparing A Farnsworth's 1939 published doctoral thesis (*The Residence and Domicil of Corporations* (1939)) with the 1975 work of Tom Magney (above n 26). While Farnsworth (at 196) concluded that *Swedish Central Railway Co v Thompson* [1925] AC 495 (the case that first mooted dual residency) was an exception to a long series of court decisions, Magney is able to conclude (at 106) that dual residency occurs where there is a division of central management and control due to Lord Radcliffe's qualification of the *Swedish Central Railway* case's principle in *Bullock (Inspector of Taxes) v The Unit Construction Co Ltd* (1959) 38 TC 712; [1960] AC 351 and other post 1939 cases such as *Koitaki Para Rubber Estates Ltd v Federal Commissioner of Taxation* (1941) 64 CLR 241; 2 AITR 167; 6 ATD 42 and *Union Corporation Ltd v Inland Revenue Commissioner* (1952) 34 TC 207.

221 Ian Gzell, 'Concepts of Residence and Source into the 21st Century' (1996) *Taxation Institute of Australia's International Tax into the 21st Century Red Series Intensive Retreat*, 10-12, and Ian Gzell, 'Residency and Permanent Establishments' (1997) *Taxation Institute of Australia 1997-98 Convention Papers*, 20, 25-6.

222 Lord Radcliffe (*Bullock (Inspector of Taxes) v The Unit Construction Co Ltd* (1959) 38 TC 712, 739; [1960] AC 351, 366) noted that "... individual cases have not always so arranged themselves as to make it possible to identify any one country as the seat of central management and control at all. Though such instances must be rare, the management and control may be divided or even, at any rate in theory, peripatetic."

223 Li, above n 193, 41; Kohl, above n 26, 445 and OECD, *Electronic Commerce: The Challenges to Tax Authorities and Taxpayer* (November 1997) para 114.

224 *Corporations Act 2001* (Cth) s 248D.

225 Li, *ibid*, 41. The problem is compounded by the fact that internet business transactions are unverifiable making evidentiary collection impossible. However, work is currently being carried on by the OECD's Technology Technical Advisory Group (TAG) on developing electronic "finger prints" which would give revenue authorities the mechanism for tracing the origins of electronic transactions, principally for GST/VAT purposes. Further details on the OECD's Committee on Fiscal Affairs TAGs can be found at URL: <http://www.oecd.org/subject/e-commerce/> as at 31 December 2003. Also see Gary Sprague and Michael Boyle, 'General Report' in *International*

. . . test causes Australian companies with foreign subsidiaries or joint venture companies to ensure that the subsidiary's management is out of Australia, and thereby minimises Australian involvement. To do otherwise would expose the foreign subsidiary's earnings (as well as actual or deemed capital gains) to tax in Australia.²²⁶

The RITA Consultation Paper also confirms that the test is avoidable by careful planning.²²⁷ However, the paper concedes that the planning can be costly, inconvenient and unnecessary (on policy grounds). The Consultation Paper also acknowledges that more uncertainty arises in a technological age (eg video conferencing, internet, etc) as the ascertainment of the residence under both non-incorporation tests is broadly based upon geographic ties determined as a question of fact.²²⁸

Given these potential avoidance problems, the "central management and control" test fails the specific criterion of prevention of tax avoidance.

3 *Voting power control test*

The third of the company residency tests in s 6(1) of 1936 Act, the voting power control test, is also easy to avoid. This fact was also recognised by Sir John Greig Latham who noted that the control test ". . . will be easily evaded. In order to escape the tax, a company will merely require that a bare majority of its shareholders are resident outside the Commonwealth."²²⁹ Also in 1930, Edward McTiernan, the then member for Parkes, noted that "[f]or the purposes of avoiding taxation, shareholders who are residents of Australia might agree to transfer their shares to persons who are residents outside Australia, who would hold the shares as trustee."²³⁰

Further, given that the judicial interpretation of the test has determined that "control" of voting power requires an actual use of power, companies can avoid Australian residency

Fiscal Association, LXXXVIa *Cahiers de Droit Fiscal International – Taxation of Income Derived from Electronic Commerce* (2001), 21.

226 Michael Wachtel and Alf Capito (Andersen), *Removing Tax Barriers to International Growth* (Business Council of Australia Discussion Paper, 11 December 2001), para 2.8.5. See also Chapter 6 of the Report.

227 RITA Consultation paper, above n 28, 54-5.

228 Ibid 54.

229 Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4859 (Sir John Greig Latham, Opposition Leader).

230 Commonwealth, *Parliamentary Debates*, House of Representatives, 29 July 1930, 4862 (Edward Aloysius McTiernan).

by simply refraining from voting.²³¹ Alternatively, the voting power could be granted to a non-resident proxy, a nominee or trustee, and the same result achieved (as the beneficial control is not actual control). Although, Kohl argues that although these gaps are theoretical there is the potential for avoidance through international share trading via the Internet.²³²

On balance, given the ease of avoidance, the test also fails the specific criterion of prevention of tax avoidance.

4 *Effective management*

The “effective management” tie breaker test in DTAs can also be manipulated. The OECD argues that the application of the test may not result in a clear determination of which country should be given preference as the country of residence, or may result in an outcome which does not appear to accord with the policy intentions of the provision.²³³

The OECD has released two discussion papers which explore a number of options to overcome the defects in the “place of effective management” tie breaker tests.²³⁴ The second paper, released on 27 May 2003 recommends two changes:

- the refinement of the place of effective management concept by expanding the Commentary explanations as to how the concept should be interpreted; and
- the adoption of a hierarchy of tests.²³⁵

231 Hamilton, above n 15, para 2.200.

232 Kohl, above n 26, 449.

233 Ibid, 8.

234 The first paper, OECD *Place of Effective Management Discussion Draft* (2001), above n 172, examined five solutions:

(A) Replace the place of effective management concept;

(B) Refine the place of effective management test;

(C) Establish a hierarchy of tests, as in the individual tie-breaker so that if one test does not provide an outcome, the next test will apply. The hierarchy suggested was place of effective management, place of incorporation, economic nexus, or mutual agreement;

(D) A combination of B and C above; or

(E) Deny dual resident companies the benefits under the Convention. Although this option does not address the issue of residence-residence conflicts resulting in double taxation, it does act as a deterrent to treaty abuse by dual resident companies.

235 OECD, *Place of Effective Management Concept: Suggestions for Changes to the OECD Model Tax Convention: Discussion Draft* (27 May 2003), 1.

The proposed hierarchy of tests is:

- the place of effective management is situated;
- if the country in which its place of effective management is situated cannot be determined or if its place of effective management is in neither country, it shall be deemed to be a resident only of the country with which its has either its economic relations are closer or in which its business activities are primarily carried on or in which its senior executive decisions are primarily taken;.
- if the country cannot be determined under the test above, it shall be deemed to be a resident of the country from the laws of which it derives its legal status;
- if it derives its legal status from neither country or from both countries, or if the country from the laws of which it derives its legal status cannot be determined, the question is settled by mutual agreement.²³⁶

The second paper puts forward three alternatives for the second tier test being, the place where:

- economic relations are closer; or
- in which its business activities are primarily carried on; or
- in which its senior executive decisions are primarily taken.

Although a hierarchy approach does attract broad support,²³⁷ such an approach does tend to favour source taxation over residency as it focuses on management rather than legal form. Further, there is no universal agreement that replacement of the “place of effective management” test with tests that are vaguer or more formalistic is necessary, merely because difficulties arise in determining the place of effective management due to the communication revolution.²³⁸

5 *Dual resident definitions*

As discussed previously, a consequence of the operation of the DTA tie breaker test is that a company can be deemed to be resident of another contracting state (and taxable in

²³⁶ Ibid, 3.

²³⁷ See, eg, Chartered Institute of Taxation (UK) *Place of Effective Management Concept*, 3 September 2003.

that state) while still being resident under Australia's domestic law and taking advantage of its resident status to access specific tax concessions (double dipping). To counter this risk the tax law contains special concession limiting rules that apply to dual residents which include two specific definitions of dual residents, a "prescribed dual resident" and "dual resident investment company".

However, the measures do not address all forms of double dipping. To overcome the difficulties associated with dual residents, the RITA Consultation Paper flagged the possibility of avoiding this complication through the adoption of the United Kingdom and Canadian²³⁹ approaches of amending the domestic definition of residency so that it is overridden where a company was taken to be a non-resident as a consequence of applying a treaty tie-breaker.²⁴⁰ That is, a company resident under Australia's domestic tax law that is resident of a treaty partner under the relevant treaty tie-breaker would be treated as non-resident for all income tax purposes.²⁴¹

The Board of Taxation recommended adoption of the deemed non-residency approach.²⁴² The Treasurer accepted that recommendation, announcing that the company residence rules will be amended so that companies that are residents under domestic income tax law, but are non-residents for the purposes of a tax treaty, are treated as non-resident for all purposes of the income tax law.²⁴³

6 Other residency rules

As discussed above (in Part II C) there are two classes of specific "residency" definitions: those applying in respect of deemed companies and those that operate for specific tax policy purposes such as the FSI rules, the dividend imputation system, and

238 JDBO (2001), above n 167, 295.

239 *Finance Act 1994* (UK) s 249 and *Income Tax Act* (Can) RSC 1985 s 250(5).

240 The OECD has gone further suggesting, as one of the solutions to defects in the effective management test, that a more stringent test of denying use of the convention to dual residents. The OECD notes that although this approach does not address the issue of residence-residence conflicts resulting in double taxation, it does act as a deterrent to treaty abuse by dual resident companies – see OECD Place of Effective Management Discussion Draft (2001), above n 172, 10. However such a test ignores the realities of dual resident companies. Although one solution to abuse in many jurisdictions is to domestically remove many of the concessions available to domestic companies, which can be double dipped by the dual resident, such provisions may fall foul of the discrimination articles in DTAs.

241 Option 3.13 RITA Consultation Paper, above n 28, 56.

242 Board of Taxation RITA Report, above n 29, 110 - Recommendation 3.13.

243 Press Release 32/03, above n 32.

thin capitalisation. These definitions either rely on the s 6(1) of the 1936 Act company residency definitions or on common concepts such as central management and control. As these tests, in the main, rely on concepts already examined, in order to avoid duplication it is not proposed to repeat that analysis.

7 Summary

From the discussion above, it is apparent that three company residency tests in s 6(1) of the 1936 Act, the dual residency definitions and the effective management test under DTAs fail to counter tax avoidance where it is carried out by companies who have mobile income sources.

E. Summary of Part III

From the above it is clear that the existing law for determining the residency of a company is inadequate. Overall it fails in identified ways to satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criteria. The major weakness in the non-incorporation residence tests is the factual element of the tests, which in certain situations:

- results in horizontal inequity;
- gives rise the lack of simplicity; and
- leaves the rules open to manipulation.

Given that the rules fail all the criteria, there is no need to address any potential conflicts in the evaluative criteria. Thus, to ensure that the company residency rules do better meet the evaluative criteria it is clear that the rules need to be reformed.²⁴⁴ The potential reform options are the focus of following discussion in Parts IV and V.

²⁴⁴ In fact as far back as 1975 the Asprey Committee (Asprey Report, above n 17, 260) found that there was " . . . a case for extending the exercise of jurisdiction to tax on the basis of residence so that all foreign income is subject to Australian tax and credit so far as administratively feasible".

IV. Exploring the sub-thesis - Models for reform of company residency rules

A. Overview

The sub-thesis is that the domestic law can be modified within the jurisdictional framework to more closely meet the evaluative criteria (ie alternative approaches to the current rules that may better satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention tax avoidance). In order to establish the sub-thesis, as in Chapter 3, a two-step approach will be adopted.

First, in this Part a review of the residency rules adopted domestically in a number of jurisdictions will be undertaken in conjunction with a selective examination of specific residency tests against the evaluative criteria. As the Australian DTAs are based upon the OECD Model Convention, and the variations away from the OCED model are identified in the analysis of DTAs in Part II, the comparative study will not encompass DTAs.

The comparative study, which focuses on domestic approaches to company residency adopted in foreign jurisdictions, will only compare and evaluate the individual residency test within the two broad approaches adopted world wide (that is, individual “fact and circumstances” and specific criteria).²⁴⁵ Although many jurisdictions combine these approaches, the focus will only be on the individual tests and will not involve a contextual examination of the residency rule (unlike Chapter 3).

This process will assist in identifying alternative models and potential solutions to the problems encountered in Australia's domestic law.²⁴⁶ Thus, in Part V, in light of the comparative analysis, a number of reform options (that are within the jurisdictional

245 An alternative classification is to divide the tests between those that focus upon formal legal connections (eg, incorporation or registry in the commercial register) and those that focus on economic or commercial connections (eg, the place of management, principal business location or less frequently, the residence of shareholders) – see Hugh Ault, *Comparative Income Taxation: A Structural Analysis* (1997), 371.

246 As noted by Review of Business Taxation, Commonwealth, *An International Prospective: An Information Paper Commissioned from Arthur Andersen Examining how other Countries approach Business Taxation* (1998) iii and 3 a review of other jurisdictions will not give a blueprint for reform as they are often struggling with the same tax issues. However, it does give some guidance in developing the best approach to resolving jurisdictional problems.

limitations) are reviewed against the evaluative criteria in order to determine whether the proposed rules are more equitable, efficient, simple and more able to prevent tax avoidance.

B. Comparing specific residency rules applicable in other jurisdictions

The following evaluation of the residency rules adopted in other jurisdictions will consider the residency tests in two categories, being:

- individual facts and circumstances tests (such as effective management, central management and control, and residence of directors or shareholders); and
- specific criteria (incorporation, seat, location of head office and voting power control).²⁴⁷

Given that a number of the foreign residency tests that have been adopted in Australia have already been extensively evaluated in the context of the Australian rules, I will not be evaluating all the approaches adopted. Such an examination would merely duplicate this earlier analysis. Therefore, the testing of specific residency tests adopted in other jurisdictions against the evaluative criteria will be limited to more unique foreign tests that have not been the subject of, or subsumed in, the previous analysis of Australia's rules.²⁴⁸ Observation will be made where the form of the common residency rule adopted in another jurisdiction overcomes some of the weaknesses identified in respect of the Australian rule.

1 Facts and circumstance tests

As mentioned above there a number of fact and circumstance tests. They can be broken up into tests that focus upon where key decisions are made (the pinnacle of management), tests focused upon the place where the business is managed and those tests focused upon the residency of the shareholder or director. The tests will be explored under these three broad headings.

²⁴⁷ Arnold and McIntyre note that there is a uniform approach adopted world wide, ie "[t]he residence of a corporation is generally determined either by reference to its place of incorporation or its place of management" - Arnold, above n 195, 23.

(a) *Pinnacle of management tests*

The first category of fact and circumstances tests is based upon the pinnacle of management tests. These tests exist in most jurisdictions, either expressly or through the operation of commercial codes. The terminology “central management and control” is used in a number of Commonwealth countries as the basis for a pinnacle of management test. As mentioned above (Part II B 3(a)) the concept of “central management and control” arose in the common law of the United Kingdom. It has been adopted through the common law (eg Canada²⁴⁹) and expressly by statute (Australia²⁵⁰).

The term “management and control” is also used to describe the pinnacle of management in Malaysia,²⁵¹ Singapore²⁵² and India.²⁵³ Although the term seems wider than “central management and control”, the case law defining “central management and control” is use used by commentators to define the scope of the “management and control” test.²⁵⁴ In Norway, although there is no definition of residency for companies, companies that are managed and controlled from Norway are treated as having their fiscal residence in Norway, regardless of where they are incorporated.²⁵⁵

Similarly, New Zealand has not adopted the “central management and control” form of words in formulating its pinnacle of management test, but through its “control by directors” test²⁵⁶ it is argued that New Zealand has adopted a statutory formulation of

248 For example, the place of management test can be used formally if the focus is on the place the directors meet, rather than economic test focused upon the stitus of day-to-day management decisions— see Ault, above n 245, 371.

249 Edwin Kroft, 'Jurisdiction to Tax: An Update' (1993) *Canadian Tax Foundation Corporate Management Tax Conference papers* 1:6, 1:25 and Jack Bernstein, 'Residence of corporations for Canadian tax' (1988) 52 *Bulletin for International Fiscal Documentation* 159, 160.

250 1936 Act s 6(1).

251 *Income Tax Act 1967* (Malaysia) s 8(1)(b). Company will be deemed to be a resident if trading in Malaysia and management and control of any one of its businesses is exercised in Malaysia.

252 *Income Tax Act (Cap 134, 2001 Ed)* (Singapore) s 2.

253 The company must be controlled and management of its affairs situated wholly in India under *Income Tax Act 1961* (India) s 6. This is the second test of a two tier test. Also see Aliff Fazelbhooy and Porus Kaka, 'India' in Timothy J Lyons and Ramon J Jeffery (eds), *IBFD: The International Guide to the Taxation of Trusts* (5 August 2003).

254 See eg, CCH Tax editors, Veerinderjeet Singh, and Teoh Boon Kee, *Malaysian Master Tax Guide* (21st ed, 2004), 51 and Angela Tan and Tan How Teck, *Singapore Master Tax Guide Handbook* (23rd ed, 2003), 31-2.

255 Confirmed in a Supreme Court (Høyesterett) landmark ruling on 20 September 2002 - Ed, 'Supreme Court decides on fiscal residence of companies under domestic tax law' *IBFD Tax News Service - Headlines* (27 November 2002). A company is normally deemed to be a resident if it is incorporated under Norwegian law - see Juhani Kesti (ed), *European Tax Handbook 2004* (2004), 489.

256 *Income Tax Act 1994* (NZ) s OE2(1)(a), fourth test of a four tier test.

that common law test.²⁵⁷ However, the “control by directors” test is a narrower test than the “central management and control” test as it is focused on ascertaining control of the company being exercised in New Zealand by its directors, acting in their capacity as directors, whether or not decision making by directors is confined to New Zealand. Therefore, the test fails to pick up the management aspects of the common law “central management and control” test.

An “effective management” test is used in many countries including Austria,²⁵⁸ Netherlands,²⁵⁹ Portugal,²⁶⁰ Romania²⁶¹ and South Africa.²⁶² As discussed above (Part II D 1(b)) although the term is similar to the United Kingdom’s concept of “central management and control”²⁶³ it is subtly different as effective management can only exist in one place.²⁶⁴

(b) *Place where the business is managed tests*

A second category of fact and circumstances test is based upon the place of day-to-day management. A “place of management” test²⁶⁵ is used in Albania, Croatia, Denmark and Germany.²⁶⁶ Similarly, a “centre of management” test is used in New Zealand.²⁶⁷ Although it is argued that the test was intended to cover the “place of executive

257 Garth Harris, *New Zealand's International Taxation* (1990) 17.

258 *Corporate Income Tax Regulations (Korperschaftsteuer-Richtlinien (KStR))*, s 6. The alternative tests company is the place which is designated its resident if has its legal seat - Hans Zochling et al, ‘Taxation of companies in Austria’ (2004) 58 *Bulletin for International Fiscal Documentation* 399, 400.

259 Kesti, above n 255, 471. There is no definition of “residence” in Netherlands corporate income tax law. Where a company incorporated under foreign law, the place of residence of a company is determined according to the circumstances. The crucial factor is the place in which the company is effectively managed. Where incorporated under Netherlands law companies are generally deemed to be resident in the Netherlands.

260 *Corporate Income Tax Code* (Portugal), Article 2(3) cited in William Cunningham ‘Portugal: The concept of corporate residence in tax law and in practice’ (1995) 35 *European Taxation* 85. The other test is a head office test.

261 Kesti, above n 255, 541. The alternative test is creation under the laws of Romania.

262 David Clegg, ‘South Africa’ in Lyons, above n 253.

263 See above n 172.

264 Owen, above n 173, 305 and Sol Picciotto, *International Business Taxation* (1992), 9. However, it is substantially similar – JDBO (2001), above n 167, 203

265 For the place of management test the location of the day-to-day management is normally decisive – see Kesti, above n 255, 167 and Ault, above n 245, 372.

266 It is the “center of management control” - see Kesti, above n 255, 43, 125, 167 and 243 respectively. The alternative test in each country is “legal seat” except for Denmark which uses incorporation.

267 *Income Tax Act 1994 (NZ)* s OE2(1)(c), third test of a four tier test.

management” the test focuses on the administrative rather than the policy or strategic decisions.²⁶⁸

(c) “*Residency of the shareholder or director*” tests

The third category of fact and circumstance test is the residency of directors or shareholders.²⁶⁹ For example, in the Netherlands residency of the directors is a factor that can determine residency²⁷⁰ and in Australia and the United Kingdom control of a company by resident shareholders can determine residency.²⁷¹ This style of test is not widely used.²⁷²

(d) *Evaluation*

The foreign fact and circumstances tests offer a narrow range of possible test criteria in order to determine whether a company has established sufficient connection with a country through to its management or by the residence of its manager or its owners. Their commonality lies in the fact that they require case by case application. As discussed above (in Part III), the individual factual nature of these tests means that in application the tests fail to deliver horizontal equity and are not simple.

Most importantly, they fail to prevent tax avoidance. The place the Board meets, which is usually the place where the pinnacle of management is exercised, is subject to manipulation (eg by splitting the board with the majority of directors resident in the desired location).²⁷³ This has become more problematic with the adoption of the European Company (*Societas Europaea*) Statute, which allows a European company to

268 New Zealand, Consultative Committee on International Tax Reform and Full Imputation, *Second Report* (July 1988) para 2.5.6 cited in Garth Harris, above n 257, 19.

269 The use of the residence of a company’s managers or officers in order to determine a company’s residence is hard to justify – see Graetz, above n 1, 1425 and Sadiq, above n 2, 13.

270 Ault, above n 245, 372.

271 However, the mere holding of shares does not give rise to residency, there must be intermeddling in the affairs of the company as if the resident is a director - Denis Sheridan, ‘Residence of companies for taxation purposes’ [1990] *British Tax Review* 78, 94 relying upon *Kodak Limited v Clark* (1901) 4 TC 549; Pierre J Bourgeois and Luc Blanchette, ‘Income_taxes.ca.com: The Internet, electronic commerce, and taxes – Some reflections: Part 2’ (1997) 45 *Canadian Tax Journal* 1378, 1396 and Gzell (1997), above n 221, 25.

272 As the purpose of corporate tax is to impose burdens on corporate shareholders, in theory, the ideal test for determining residency should be the residency of the shareholders – see Arnold, above n 195, 23 and below, Part V B 3(a).

273 Li, above n 193, 41. Another reason is that a change in the place of management can be achieved without triggering a tax liability – Arnold, above n 195, 23.

opt for a two-tier board structure. This means any pinnacle of management test will have to be applied across both a supervisory and a management board.²⁷⁴

Similarly, the place where the directors/shareholders reside also has a number of problems due to internationalisation of company boards, the adoption of two tier boards and the use of bearer shares in a number of jurisdictions.²⁷⁵

Thus, the foreign facts and circumstance tests, other than offering a range of possible test criteria, provide little guidance for reform as they too do not satisfy the evaluative criteria.

2 *Specific criteria tests*

There are two categories of specific criteria tests. They are place of creation (which includes incorporation, formation, domicile and seat), and place of head office or registered office. The following explores the scope of each of the tests before making some observations on the effectiveness of the tests.

(a) *Creation tests*

Incorporation is used as a sole test in the United States and Ireland²⁷⁶ and as an alternative test in Canada,²⁷⁷ Greece,²⁷⁸ India,²⁷⁹ Indonesia,²⁸⁰ New Zealand,²⁸¹

274 Ed 'UK implementation of European Company Statute' *IBFD Tax News Service - Headlines* (29 September 2004).

275 The test is also difficult to apply where the shares are held by residents of more than one country – Arnold, above n 195, 23.

276 *Taxes Consolidation Act 1997* (IRE) s 23A. Incorporation replaced a common law “central management and control” test from 11 February 1999 - see William Cunningham, ‘Irish-incorporated companies – New Residence rules’ (1999) 53 *Bulletin for International Fiscal Documentation* 476 and John Kilcullen, ‘Irish non resident companies – The end?’ (1999) 12 *Irish Tax Review* 385.

277 *Income Tax Act* (Can) RSC 1985 (5th Supp) (as amended) s 250(4) deems a corporation to have been resident in Canada throughout a taxation year if it was incorporated in Canada after 26 April 1965. It is an alternative to a common law central management and control test. Special rules apply (*Income Tax Act* (Can) s 250(4)(b) and (c)) apply special rules for companies formed prior 27 April 1965 (based upon incorporation and was resident in or carried on business in Canada) and for foreign business corporation formed before 9 April 1959 and controlled by a corporation resident in Canada (based on similar incorporation, resident and business tests combined with dividend receipts).

278 Kesti, above n 255, 271.

279 The company is required to be formed and registered under *Companies Act 1956* (India) under *Income Tax Act 1961* (India) s 6. This is the first test of a two tier test. Also see Aliff Fazelbhoj and Porus Kaka, ‘India’ in Lyons, above n 253.

Norway,²⁸² and the United Kingdom.²⁸³ Other tests used in other jurisdictions are “formation”,²⁸⁴ “registration”,²⁸⁵ “created”,²⁸⁶ and “domicile”.²⁸⁷

The “seat” (*sitz, siege*) of the corporation is used as a residency test in a number of civil law countries including Albania,²⁸⁸ Austria,²⁸⁹ Croatia,²⁹⁰ and Germany.²⁹¹ The seat of a company is a test similar to incorporation but is wider based upon the place where the company was first incorporated, the jurisdiction where the memorandum has been lodged and where the company has its head office.²⁹²

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- 280 *Law Number 10 Year 1994* (Indonesia) Article 2 (3)(b): the first test of a two tier test. A corporation is a limited liability company, limited partnership, other partnerships and state owned corporations, an alliance, a society, a firm, a kongsi, a cooperative, a foundation, an institute or a pension fund – Explanatory notes, Law of the Republic of Indonesia (No 10 of 1994) reproduced in S Sutanto, 2B(II) *Taxation Laws of Indonesia* (loose leaf service).
- 281 *Income Tax Act 1994* (NZ) s OE2(1)(a): the first test of a four tier test.
- 282 Although there is no definition of residency companies, in practice they are residents if incorporated in Norway - Kesti, above n 255, 489.
- 283 A company is "resident" if incorporated in the United Kingdom after 15 March 1988 - *Finance Act 1988* (UK) s 66. Also see Geoffrey Pink, 'A commentary on the United Kingdom Budget 1988' (1988) 28 *European Taxation* 139, Robert Walters, 'A guide to trading in the United Kingdom' (1992) 32 *European Taxation* 270 and Denzil Davies, *Booth: Residence, Domicile and UK Taxation* (1995), 135-9.
- 284 Formation is used in South Africa (Ernest Mazansky, 'South Africa changes to a worldwide system' (2001) 55 *Bulletin for International Fiscal Documentation* 138, 140), while in France, although residency is not defined, formation under French law and having a registered office in France is sufficient (Ault, above n 245, 373).
- 285 In Sweden registration with the Swedish Patent and Registration Board is required - Ault, above n 245, 371.
- 286 Hungary - see Kesti, above n 255, 299.
- 287 *Law Number 10 Year 1994* (Indonesia) Article 2 (3)(b): the second test of a two tier test. It is a place of creation test. The domicile of company under common law is in the jurisdiction of the state in which it was created (its "... domicile of origin, or the domicile of birth") – see *Gasque v Inland Revenue Commissioners* (1940) 23 TC 210, 215 (Macnaghten J) and *Bergner and Engel Brewing Company v Dreyfus* 70 American State Reports 251. Also see Baldwin, above n 26, 172, A Farnsworth, *The Residence and Domicil of Corporations* (1939), 273-4 and United Kingdom, *Report of the Income Tax Codification Committee* Cmd 5131 (1936), 41-2.
- 288 Kesti, above n 255, 43. The alternative test is “place of management”.
- 289 *Corporate Income Tax Regulations (Korperschaftsteuer-Richtlinien (KStR))*, s 6. The legal seat is the place which is designated as such under the Commercial Code. The alternative test is “place of management” – see Hans Zochling et al, 'Taxation of companies in Austria' (2004) 58 *Bulletin for International Fiscal Documentation* 399, 400.
- 290 Kesti, above n 255, 125. The alternative test is “place of management”.
- 291 In order to be properly constituted a German Company must have its *sitz* in Germany (ie where a company's statutory records and accounts are kept) The Commercial Code also requires that there must be a company director (*Geschäftsführer*) who must be an individual competent and able manage the company at that site - Owen, above n 173, 304.
- 292 Couzin, above n 1, 3,4 and Peter E Nygh and Peter Butt (eds), *Butterworths Australian Legal Dictionary* (1997), 1053.

(b) *Location of head office or registered office*

A second objective criterion is the location of the head office or registered office. These tests are used as a sole or alternate test in a number of countries including Korea,²⁹³ Japan,²⁹⁴ New Zealand,²⁹⁵ Slovenia²⁹⁶ and Portugal.²⁹⁷ A company's head office is generally the place where its business is carried on.²⁹⁸

(c) *Evaluation*

The use of the "creation" and "registered office" tests to determine residency and a world wide tax liability results in a lack of horizontal equity (ie taxpayers in similar economic circumstances are not treated similarly) through double taxation of dual residents arising from one state using incorporation while another state uses a pinnacle of management test to determine residency. Double taxation will occur for the dual resident in the absence of double tax relief under DTAs and if the country of citizenship does not fully credit or exclude income taxed in country of residence.

On the other hand, the "creation" and "registered office" tests generally satisfy the simplicity criterion (as the rules apply in a predictable way), they are not complex (resulting in low compliance costs), and are expressed clearly.

However, the tests tend to fail the prevention of tax avoidance objective. The incorporation test fails the tax avoidance criterion as it "... basically allows taxpayers to decide whether they want to pay tax on a residence basis or source basis."²⁹⁹ Even the "seat" concept can be used to manipulate residency,³⁰⁰ while the "location of head

293 Korea, Ministry of Finance and Economy, *Korean Taxation* (2002): sole test.

294 *Corporation Tax Law* (JPN), s 2 - see Hideaki Sato, 'Japan' in Lyons, above n 253. The Japanese corporate residency test arises not from tax law but from the *Civil Code* and the *Commercial Code*. Under the *Commercial Code* all companies incorporated in Japan must have registered headquarters in Japan - Ault, above n 245, 371.

295 *Income Tax Act 1994* (NZ) s OE2(1)(b): the second test of a four tier test.

296 Kesti, above n 255, 591.

297 *Corporate Income Tax Code* (Portugal), Article 2(3). The head office is the company's statutory seat (sede) which implicitly includes in corporation - cited in Cunningham, above n 260, 86. The alternative test is an "effective management" test.

298 *American Thread Co v Joyce* (1913) 6 TC 163.

299 Li, above n 193, 41.

300 Owen, above n 173, 304 notes that a United Kingdom effectively managed German incorporated company would be found to satisfy the Germany residency test by ensuring that at the board meeting held in the United Kingdom the one German resident *Geschäftsführer* attends, but is out numbered by his/her United Kingdom colleagues.

office” test also can fail the prevention of avoidance criterion due to the availability of instantaneous and global facilities, which in turn allows manipulation of the place where business is being carried on.³⁰¹ Thus, the “specific criteria” tests fail to satisfy the specific criterion of prevention of tax avoidance, as they are easy to evade.³⁰²

3 Other residency rules

For completeness, it is important to note that there exists a number of special purpose residency tests designed to overcome specific problems or to assist in the establishment of country specific entities. For example, to stop double dipping a number of countries (including United Kingdom³⁰³ and Canada³⁰⁴) have adopted tests that treat a resident company, that is deemed under a treaty tie-breaker test to be a non-resident, as a non-resident for the purposes of the tax law. As discussed above these tests do promote horizontal equity and prevent tax avoidance.

Similarly, New Zealand also has special residency definitions under its CFC regime that override the general residency definition,³⁰⁵ while Canada has special residency rules for continued corporations³⁰⁶ and international shipping corporations.³⁰⁷

As with the Australian specific purpose tests (see Part II C), these tests rely on concepts already examined in the context of fact and circumstances and specific criteria tests (eg

301 ATO’s first Internet Report, above n 218, para 7.2.21.

302 Hamilton, above n 15, para 2.180 and Vann (1995), above n 16, 6.

303 *Finance Act 1994* (UK) s 249.

304 *Income Tax Act* RSC C 1985 (Can) s 250(5).

305 *Income Tax Act 1994* (NZ) s CG 13(1)(a). Under the CFC test a CFC is resident in grey list country only if it is liable to income tax in the country because the CFC has any of the following in the country: its domicile: its residence: its place of incorporation: or its place of management.

306 *Income Tax Act* RSC C 1985 (Can) s 250(5.1). Where a corporation, not incorporate in Canada is at any time granted articles of continuance (or similar constitutional documents) in a particular jurisdiction, the corporation shall for the purposes of this Act be deemed to have been incorporated in the particular jurisdiction and not to have been incorporated in any other jurisdiction. Where a corporation is incorporated in Canada and is granted in a different jurisdiction will be deemed to have been incorporated in the particular jurisdiction at the time of continuation and not to have been incorporated in any other jurisdiction.

307 *Income Tax Act* RSC C 1985 (Can) s 250(6). A corporation that was incorporated or otherwise formed under the laws of a country other than Canada shall be deemed to be resident in that country throughout a taxation year and not to be resident in Canada at any time in the year, where the corporation, or its wholly owned, deemed non-resident subsidiary/ies has/have as its principal business in the year the operation of ships that are used primarily in transporting passengers or goods in “international traffic” (as defined in s 248(1)) and all the corporation's gross revenue for the year consists of gross revenue from the operation of ships or dividends from other wholly owned, deemed non-resident corporations.

incorporation, place of management, etc). Therefore, in order to avoid duplication it is not proposed to repeat that analysis.

4 Balancing the rules

In examining the company residency rules operating in Australia and other jurisdictions, both the “fact and circumstance” and the “specific criteria” tests have been examined in isolation. This approach tends to emphasise the weaknesses inherent in each of the rules. However, most countries use a combination of tests, usually an incorporation test combined with a pinnacle of management test.³⁰⁸ The use of multiple tests tends to overcome some of the avoidance concerns but increases the scope for horizontal inequity due to increasing the potential for double taxation. Simplicity is also reduced in these circumstances.

C. Summary

The models of corporate residency in use elsewhere in the world are merely variants of the tests adopted in Australia. Thus, they incorporate the defects identified in the analysis of the Australian tests and contravene the good tax law criteria. Therefore, the company residency rules that operate in other jurisdictions offer no clear solutions and little guidance for reform.

V. Reform options for corporate residency

A. Overview

In Part III of the thesis it was established that Australia’s current rules for determining the residency of a company fail the evaluative criteria of equity, efficiency, simplicity

308 The number of the tests vary, with New Zealand using four tests, while the United States uses only one, the incorporation test. There has been academic support for the use of multiple factors (including the source/location of capital (intellectual capital, the factors of production and the source of capital), technology and management skills) in order to assign residence to the jurisdiction which gives the corporation economic life. A multi-tier approach overcomes the risk associated with one dominant factor determining residency, which, as seen above, will not necessarily give rise to a correct finding of residency and could be manipulated. However, this approach is more conceptually robust than it may be in practice. See David R Tillinghast, ‘A matter of definitions: “Foreign” and “domestic” Taxpayers’ (1984) 2 *International Tax and*

and the prevention tax avoidance. In order to explore the sub thesis, that the law can be modified within the jurisdictional framework to more closely meet the evaluative criteria, a review of residency models adopted in other jurisdictions was conducted in Part IV.

Although it was established that no individual country's model or particular residency test satisfied all the evaluative criteria, the process did reveal a number of refinements which, with further analysis, may provide the basis for modification of Australia's domestic law so that it more closely meets the evaluative criteria.³⁰⁹ Thus, the purpose of this Part is to explore the approaches for modifying the existing rules such that they better meet the evaluative criteria.

As discussed in Chapter 3 (Part V A), as the policy objectives do conflict any modification to existing laws can result in one evaluative criterion being favoured over another. Therefore, as stated in Chapter 2, where the tax policy objectives are in conflict, in seeking to evaluate the adequacy of a reform option the principal focus will be on ensuring equity. However, where equity objective leads to negative outcome in terms of complexity (simplicity) and tax avoidance, the reform option that provides a balance between the equity tax policy objective and the simplicity and anti-avoidance tax policy objectives will prevail.

Therefore, the approach adopted for reform involves changing some of the existing tests from the facts and circumstance model to arbitrary number of days or specific criteria models (ie trading-off equity for simplicity and the prevention of tax avoidance).

B. Reform options

Having clarified the evaluative methodology, the next step is to consider each of the residency rules and determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. The process will be to consider the various reform options in respect of each of the residency rules before

Business Law Journal 239, 252-72, cited in Michael J Graetz, *Foundations of International Income Taxation* (2003), 110.

309 The Board of Taxation indicated that the definitions can be rewritten based upon the existing rules – see The Board of Taxation, Commonwealth, *Tax Value Method Demonstration Legislation Prototype 4*, (6 March 2002), ss 4-15 and 995-1 at URL: <http://www.taxboard.gov.au> as at 31 December 2002.

settling on the preferred approach. This analysis will be undertaken in addressing the jurisdictional rules currently adopted, which are:

- incorporation in Australia;
- control by directors of a non-resident company carrying on business in Australia; and
- control by Australian shareholders of a non-resident company carrying on business in Australia.

1 Incorporation in Australia

(a) Evaluating options for reform

As discussed above (Part III D) both the RITA Consultation Paper³¹⁰ and the Board of Taxation explored the suggestion of moving to a test of company residence based solely on place of incorporation, as in the United States.³¹¹ Both papers argued that the avoidance risks, in particular from “company inversion”, are unlikely to occur as features such as a developed transfer pricing regime, the FSI rules and dividend imputation would reduce the risk to Australia of relying on place of incorporation as the sole test of residency. However, neither paper discussed whether the incorporation test could be reformed to ensure that it better meets the evaluative criteria.

Based upon the previous analysis, the incorporation test is simple and efficient, and internationally it is used as the primary residency test in many jurisdictions (eg the United States and the United Kingdom). However, horizontal equity suffers under the test as companies with no attachment to Australia other than incorporation are taxed on their world wide income while companies who conduct significant business in Australia and benefit from its infrastructure are able to evade tax on offshore operations.³¹² Also, the anti-avoidance object is not well served, as often form over substance will prevail.

310 RITA Consultation Paper, above n 28, 54-5.

311 Board of Taxation RITA Report, above n 29, 106-9 - Recommendation 3.12. There also exists both academic and business support for this approach – eg, see Vann (1995), above n 16, 1 and various industry submissions, above n 212, respectively.

312 However, the use of DTAs can moderate or remove the potential inequity where the operation is a permanent establishment.

Despite these failing the other tests identified internationally (the “creation” and “registered office” tests) also have similar failings.

(b) Finding the balance

In order to maintain the jurisdictional claim an incorporation test needs to be retained. There are no changes that can be recommended that ensure the test more closely meets the tax policy objectives.

2 Control by resident directors of a non-resident company carrying on business in Australia

(a) Evaluating options for reform

Given the similarity between all the “pinnacle of management” tests reviewed, there is not one test which offers a clear alternative to the “central management and control” test that better meets the evaluative criteria. For example, it has been suggested that an approach would be to replace the “central management and control” test with the civil law derived “effective management” test.³¹³ However, although the test conceptually may increase certainty (simplicity) (as under the “effective management” test there can only be one place of effective management) and it would also be consistent with tie-breaker test in DTAs, simplicity is not improved as the term lacks definitional certainty (see Part III C 1). Also, the test still can be manipulated through the use of special purpose subsidiaries (see Part III D 4) and thereby fails the prevention of avoidance criterion.

A second approach is to make the test more objective by capturing in statute the key elements of the “central management and control” test. This could either be by including more objective criteria in the hierarchy test (similar to the New Zealand approach which includes the place of day-to-day management) or by a check list approach which determines residency according to where the majority of elements on a list (such as location of head office, residency of directors, residency of Chief Executive Officer, etc) indicate residency lies.³¹⁴ Although the introduction of more objective criteria would

313 Vann (1995), above n 16, 7.

314 The location of head office was used as a basis for taxation in Australia’s first income tax Act, the *Real and Personal Estates Duty Act 1880* (Tas) s XXXIX. Cf Sheridan, above n 271, 106, who

enhance simplicity (by providing certainty and lowering administrative and taxpayer compliance costs), they may impact adversely on horizontal equity (by increasing potential for double taxation) and would still be subject to manipulation.

A third approach is to restore the original jurisdictional scope of the “central management and control” test³¹⁵ by amending the law to ensure that exercising “central management and control” alone does not constitute the carrying on of a business (ie reversing *Malaysian Shipping*³¹⁶).³¹⁷ This change would reduce horizontal inequity and minimise compliance costs by narrowing the range of non-resident companies caught under the current judicial interpretation of the “central management and control” test.

(b) *Finding the balance*

As with the incorporation test there is no clear alternative to the “central management and control test”. The inclusion of more objective criteria under a hierarchy or check list approach does offer a practical alternative. The level of manipulation would be moderated by the existence of FSI, and transfer pricing rules. However, both the hierarchy and check list approach could result in a narrowing (expansion) of the jurisdictional claim when compared to a finding in similar circumstances using the current judicial interpretation of the test. Therefore, inclusion of discrete determinative objective criteria to the test cannot be supported in the context of the sub-thesis as it would be a variation of the jurisdictional claim.

However, statutorily overruling *Malaysian Shipping* (by amending the law to require a carrying on of a business to be first established, before looking at central management and control) would restore the original jurisdictional claim. This change would reduce

recommends that in any reform of residency rules practical indicators, such as a registered office, should be disregarded as criteria for determining residence.

315 The inclusion of the “carries on business in Australia” element in the test and the creation of specific provisions to deal with shareholder control seems to suggest that the test was intended only apply to those non-resident companies trading in Australia, where the pinnacle of management was also located in Australia – see Note on Clause 2 in Explanatory Notes, Bill to Amend the Income Tax Assessment Act 1922-1929 (Cth), 11. Also see Ratcliffe, above n 27, 105-6, which in 1938 suggests that the phrase could mean “. . . ‘carries on its trade or other operations in Australia’ as distinct from the management and control of those operations.”

316 *Malayan Shipping Co v Federal Commissioner of Taxation* (1946) 71 CLR 156; 8 ATD 75, 3 AITR 258.

317 The RITA Consultation Paper suggests that reform should be focused on an option to clarify the test of company residency so that exercising “central management and control” alone does not constitute the carrying on of a business – see RITA Consultation Paper, above n 28, 54-5.

horizontal inequity and improve simplicity through the reduction in compliance costs of companies, seeking to avoid attracting residency under this test (see Part III C 3).

Thus, by changing the “central management and control” test by statutorily overruling *Malaysian Shipping* will result in the test more closely meeting the tax policy objectives of horizontal equity and simplicity.

3 Control by Australian shareholders of a non-resident company carrying on business in Australia

(a) Evaluating options for reform

As noted above, the “voting power control” test fails the prevention of tax avoidance (Part III D 3) and the simplicity evaluative criterion (Part III C). Due to a need for actual control by share holders it is easily avoided. There are also difficulties in determining the residency of the shareholders. However, there are a number of ways the control test could be reformed.

First, the “control” test in the “voting power control” test could be replaced by a “beneficial ownership” test. However, such a test would require extensive tracing rules, which would add enormous complexity, thereby reducing simplicity. Further, as tracing rules have not worked domestically in the tax context and internationally in the company law context,³¹⁸ and the linkage of corporate residency to its owners is not practical in the context of multi-tiered multinationals,³¹⁹ such a change is unlikely to prevent tax evasion. Further, by expanding the scope of the test the opportunity for double taxation increases and a reduction in horizontal equity is the result.

An alternative approach is to expand the control test to foreign subsidiaries controlled by Australian shareholders (ie a parent company).³²⁰ This could be achieved by

318 Vann (1995), above n 16, 7. A further extension of the “beneficial ownership” test is a full integration model, where corporate veil is lifted such that the income of the company (distributed and retained) is allocated, like a partnership, to each individual share holder who is personally liable for tax. It is based on the premise that companies exist for the benefit of shareholders. However, the full integration model merely exaggerates the same weaknesses of the beneficial ownership test (as discussed above) - see Patrick Sedgley, ‘The role of the residence concept in tax policy’ (Paper presented at the *ATO Advanced Workshop on Residency*, Sydney, 30 August 1995).

319 Graetz, above n 1, 1425.

320 This approach is based on the argument that a foreign subsidiary of an Australian resident company should be taxed in Australia as this is where it is subjected to the overall control of the

removing the “carries on business” element of the test, leaving the voting power control test as the sole test.³²¹ To prevent avoidance, the control test could be expanded to include alternative indications of control, such as control over dividends or entitlement to share in distributions on wind up and effective control acquired through association of shareholders (ie akin to the CFC control mechanisms in s 340 of the 1936 Act). Further, it is argued that if the test were expanded in this way, then simplicity would be increased as there would be no need for the comprehensive CFC legislation as all CFCs would be Australian residents, taxable in Australia.³²²

This approach would increase the jurisdictional scope of the tax law to tax all income of non-resident companies resident in non-DTA countries, but would increase non-compliance by allowing income derived in DTA countries (that is currently caught under the CFC rules), to escape. This later problem occurs as Australia under its DTAs has conceded that subsidiaries will be treated as residents of the foreign contracting state and are principally taxable in that state. As a result, the timing for recognition of income would shift back to a deferred basis and Australia would not be able to tax income concessionally taxed in the other DTA state.

Thus, although this approach appears to improve simplicity, horizontal inequity is increased for companies resident in non-DTA countries and tax deferral would be increased through the removal of the CFC rules.

It is argued that rather than modify the test it should be repealed. The CFC rules offer a good proxy as they balance the horizontal inequity arising from full accrual and do focus upon areas where tax avoidance is more likely to occur.³²³ However, such CFC regimes in turn can create horizontal inequity where more than one country seeks to tax the same concessionally taxed income.³²⁴

Australian parent – see Robert Deutsch, ‘An Overview of the International Tax Legislation’ (1992) (*Cross-Border Chaos*) (Paper Presented at Taxation Institute of Australia, New South Wales Intensive Seminar, 1992) 4.

321 Ibid.

322 Ibid 5. Deutsch asserts that there are no constitutional or jurisdictional limitations to such an expansion.

323 Vann (1988), above n 22, lxxvi.

324 Ibid, lxxvii.

(b) *Finding the balance*

[M]any commentators argue, [as] the purpose of the corporate tax is to impose tax burdens on the corporation's shareholders, then the test of residence of a corporation might be determined, at least in theory, by reference to the residence of its shareholders.³²⁵

However, given the “voting control” test has little practical operation and that the other suggested reforms result in expansion of the jurisdictional claim, the only practical way of simplifying the law is to repeal the test.

In summary, within the strict criteria of the sub-thesis the repeal of the “voting control” test would amount to a minor variation in the jurisdictional claim. However, its removal will ensure that the domestic law of company residency more closely meets the “essential objectives” of simplicity, be it within a slightly narrower jurisdictional framework.

4 *Specific residency tests*

As discussed in Part III, the specific company “residency” definitions in respect of deemed companies and those that operate for specific tax policy purposes either rely on the s 6(1) of the 1936 Act company residency definitions or on common concepts such as “central management and control”. There are some specifically related elements such as “formation”, “location of property in Australia” and “50% of beneficial interest in the income or property in Australia”. Therefore, as reform principally lies in modification of those other tests, it is not proposed to review reform options in detail. However, simple changes such as using a common “resident unit trust” definition (instead of two identical definitions in ss 102H and 102Q of the 1936 Act) ensures that the domestic law of company residency more closely meets the “essential objectives” of simplicity.

325 Arnold, above n 195, 23.

5 DTAs

(a) *Evaluating options for reform*

As noted above (Part III A 2 and C 1 and 5), Australia's DTAs have been developed through country by country negotiation, the tie breaker tests adopted and the order in which they appear varies from DTA to DTA. This variation creates inconsistency and complexity. Also, a lack of horizontal equity inherently arises from the existence of DTAs, as only residents of the States that are parties to the treaty can avail themselves of the DTA tie breaker test. As a result some dual resident companies in a DTA country will be treated differently to those dual resident companies from non-DTA countries.

(b) *Finding the balance*

As noted in Chapter 3 (Part V B 6), the horizontal inequity issue should be short term, as the government in 2003 agreed to escalate Australia's future DTA negotiation program. Also, Australia, in DTA negotiations, should generally follow the tie breaker test in Article 4 of the OECD Model Convention. The effect over time, as treaties are renegotiated, will be that the law of company residency, within the jurisdictional framework, will more closely meet the "essential objective" of simplicity.

6 *Miscellaneous changes*

Finally, there is one minor change, which if adopted may improve simplicity without adversely impacting upon the other policy objectives. There is a need for clear start and end dates for companies which are resident for only part of an income year (see Part III C 6). Such a change would ensure that the law of company residency, within the jurisdictional framework, will more closely meet the "essential objective" of simplicity.

C. Summary

In the above analysis each of the company residency rules was examined to determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. It has been recommended to repeal the "voting power test and to amend the "central management and control" test to restore the "carries on business"

element of the test. In main the changes recommended are only those minor changes which do not extensively modify the jurisdictional claim. These changes, combined with some technical alterations will result in the company residency rules in a minor way better meeting the evaluative criteria. However, greater improvement could be achieved through more major variations to the jurisdictional claim.

VI. Trusts - Exploring the Main Thesis

Having completed the evaluation of the company residency rules, the next step is to repeat the process for trusts, with Part VI exploring the operation of the residency rules relating to trusts. This first involves exploring the principal residency tests contained in s 95(2) of the 1936 Act before exploring the scope of other residency definitions. For completeness it is important to explore the impact of DTAs, if any, on the scope of the domestic trust residency rules.

The examination in this Part will provide the necessary basis to enable evaluation of those rules against the evaluative criteria of equity, efficiency, simplicity and prevention of tax avoidance (in Part VII). As mentioned in the introduction, where the residency tests for trusts have common features, discussion will not be repeated; rather the discussion will focus on the specific features of the test in that context.

In Part VIII a comparative analysis in respect of trusts will be undertaken in light of this analysis, before evaluating (in Part IX) against the evaluative criteria in order to determine whether the proposed trust rule reforms are more equitable, efficient, simple and more able to prevent tax avoidance.

However, prior to exploring the scope principal residency rules applicable to trusts, the preliminary step is to define what a trust is in this context.

A. Defining a trust

In Australia a trust is described as an arrangement enforceable in equity where one person (the trustee) holds property (the trust property or corpus) for the benefits of

another (the beneficiary) or for the advancement of certain purposes permitted by law.³²⁶ Thus, it is not a separate legal entity. As “[e]quity fashions a trust with flexible adaptation to the call of the occasion” over many centuries it is difficult to define a trust more accurately than the above description of its major features.³²⁷

There are broadly three types of trusts: express, implied (resulting) and constructive trusts.³²⁸ Express trusts arise where there is an express declaration on the part of the settlor. This can arise through deed or by will (inter vivos). Forms of express trusts are discretionary, fixed, hybrid, unit, trading (cash management, property, mortgage and equity) and blind trusts, and many superannuation funds.

An implied trust arises from the words or conduct of the parties in circumstances that the law presumes that a trust was intended. Finally, a constructive trust arises when courts impose a trust, even where no trust was intended, on a person for the benefit of another, where the person has control of property obtained through unconscionable conduct. An example is the case of *Zorby v Federal Commissioner of Taxation*³²⁹ where misappropriated funds in the embezzler’s bank account were held by the Federal Court to be held on trust for the benefit of the employer.

In essence, the existence of a trust imposes obligations on a trustee, who can only deal with that trust property for the benefit of the beneficiary or for the specified purpose. Outside any express powers and obligations in the instrument creating a trust, each Australian state and territory has acts, based upon nineteenth century English legislation, which impose certain obligations and confer certain powers on trustees.³³⁰

326 HAJ Ford and WA Lee, *Principles of the Laws of Trusts* (September 2004), para 1000, RP Meagher and WMC Gummow, *Jacobs’ Law of Trusts in Australia* (5th, 1986), 7 and Lehmann, above n 86, 1052. Underhill, *Law of Trusts and Trustees* (12th ed, 1970), 3 defines a trust as “an equitable obligation, binding a person to deal with property, over which he has control, for the benefit of persons to whom he may himself be one, and any one of who may enforce the obligation.”

327 *Adams v Champion* (1935) 249 US 231, 237 (Cardozo J) cited by Sir Laurence Street in ‘Foreword to the fourth edition’, in Meagher, *ibid*, v. Also see Mark Leibler, ‘Pitfalls of operating businesses through trusts’ (1978) 7 *Australian Tax Review* 17

328 See generally Ford, above n 326, Meagher, *ibid*, 57-58 and Lehmann, above n 86, 1053-4.

329 (1995) 30 ATR 412; 95 ATC 4251.

330 See *Trustees Act 1957* (ACT), *Trustee Act 1925* (NSW), *Trustee Act 1979* (NT), *Trusts Act 1973* (Qld), *Trustee Act 1936* (SA), *Trustees Act 1898* (Tas), *Trustee Act 1958* (Vic), and *Trustees Act 1962* (WA). See generally Ford, above n 326, Ch 12, Meagher, above n 326, Ch 17 and Lehmann, above n 86, 1053.

As a trust is not defined under the 1997 Act, the equity concept of a trust operates for the purposes of Act.

B. Taxation of trusts

The starting point for determining the income of the trust is to deem, for the purposes of the calculation of net income in s 95(1) of the 1936 Act, that the trustee is a resident. However, as a trust is not a separate legal entity (it is a flow-through “structure”), the basic scheme of trust provisions is to attach the taxation liability for net income derived by the trust on the beneficiary, to the extent that the beneficiary is presently entitled to that income.³³¹ Such a distribution is statutory income assessable under s 6-10 (via s 10-5). There are also special rules to tax Australian resident beneficiaries of non-resident trusts.³³²

Where there is a possible impediment to collection of tax (eg the beneficiary is under age, insolvent or a non-resident), or the income is retained by the trustee, the taxation liability is attached to the trustee by ss 98, 99 and 99A to 99D of 1936 Act. In these circumstances the trustee is the entity subject to tax under the 1997 Act.³³³

C. Defining the scope of the residency rules for trusts

The exploration of the scope of the principal residency rules applicable to trusts contained in s 95(2) of the 1936 Act will be undertaken by first providing an overview of the rules and their interrelationship before exploring the scope of each of the rules in detail.

1 Overview of the principal residency rules

The residency status of a trust, for the purposes of Division 6 of Part III of the 1936 Act, is determined by the application of the definition of a “resident trust estate” in s 95(2) of

331 Division 6 of Part III of 1936 Act is the main provision that taxes trusts. It and other provisions set out in the 1936 Act are adopted directly into the 1997 Act and operate as if they were part of the 1997 Act (see Schedule 1, item 2 of the *Income Tax (Consequential Amendments) Act 1997* (Cth) that alters the definitions of “this Act”, “taxable income”, “income tax” and “assessable income” in s 6(1) of the 1936 Act).

332 1936 Act ss 96A to 96C, 99D, Div 6AAA of Part III (transferor trust) and Part XI (FIF).

the 1936 Act. This test was only enacted in 1979³³⁴ following recommendations from the Asprey Committee.³³⁵ The Asprey Committee found that in light of the decision of the High Court in *Union Fidelity Trustee Co of Australia Ltd v Federal Commissioner of Taxation*³³⁶ that the former Division 6 of the 1936 Act did not have a jurisdictional basis, resulting in the foreign source income earned by a trust not being assessable.³³⁷

A trust will be a "resident trust estate" in a year of income under s 95(2) if:

- a trustee of the estate was a resident at any time during the year or
- the central management and control of the trust estate was in Australia at any time during the year.

Thus, the definition contains two alternative statutory tests for determining residency: "the residency of the trustee" test and a "central management and control" test. The scope of those tests is explored briefly in the following.

2 Scope of the residency of the trustee test

The test is wider than that suggested by Asprey, as residency will be found if one trustee is a resident. Asprey suggested that where there was more than a sole trustee, that residency would be found if a majority of the trustees were resident.³³⁸ There are two elements to the "residency of the trustee" test: that is, there must be a "trustee" and the trustee must be a resident.

Who is a "trustee" is defined in s 6(1) of the 1936 Act (via s 995-1) to cover a wide range of persons.³³⁹ A trustee includes an executor, administrator, guardian, committee,

333 Although a "trust" is an "entity" under the 1997 Act (s 960-100 (1)(f)), it is the trustee who is deemed to be the entity (1997 Act s 960-100(2)) and responsible for the tax (1997 Act s 9-1).

334 A definition of "resident trust estate" was introduced by the *Income Tax Assessment Amendment Act 1979* (Cth) - originally introduced as the *Income Tax Assessment Amendment Bill (No 5) 1978* (Cth).

335 Asprey Report, above n 17. The recommendations were set out in paras 15.54-15.62. The residency test recommendation is contained in para 15.59.

336 (1969) 119 CLR 177; 1 ATR 200; 69 ATC 4084.

337 See Commonwealth, *Second Reading Speech, Income Tax Assessment Amendment Bill (No 5) 1978* (Cth) House of Representatives, 23 November 1978 (John Howard, Treasurer) reproduced in Butterworths, 8 *Taxation Laws of Australia: Legislation and Official Explanations (1977-1978)*, 1051, 1052 and Explanatory Memorandum, *Income Tax Assessment Amendment Bill (No 5) 1978* (Cth), 16.

338 Asprey Report, above n 17, para 15.59.

339 Broadly, trustees can be appointed, or constituted to be trustees by the actions of parties, by order or declaration of a court, or by operation of law.

receiver, liquidator, and every person having the administration of an estate, control of income affected by any express or implied trust, acting in any fiduciary capacity, or having the possession, control and management of the income of a person under any legal or other disability.

The rules for determining the residency of a trustee will be determined by the nature of the trustee: that is, whether the trustee is an individual or a company. As the residency rules for individuals have been explored in Chapter 3 and the residency rules for companies in Parts II and III, there is little need to duplicate that analysis. Thus, the residency status of a trustee will be determined according to the rules in s 6(1) of the 1936 Act and those specialised definitions (as discussed above in Part II B and C).

3 Scope of the central management and control of the trust test

The second trust residency test is the “central management and control of the trust”. Unlike the central management and control test for companies, there is not a carries on business in Australia element to the test. However, as the High Court decision in *Esquire Nominees Ltd v Federal Commissioner of Taxation*³⁴⁰ has been used in the company context to clarify the meaning of the term “central management and control”, it is likely that the words “central management and control” in the trust context have a meaning similar to that in the company context. Again, as the scope of this test has been explored above (Part II B 3), it is not proposed to restate that examination. However, there are some conceptual problems in applying the test to trusts, as “the central management and control of a trust” does not sit easily with the essence of a trust (that is, being a set of obligations in respect of property).³⁴¹

4 Summary

The rules that determine residency of trusts are drawn from concepts used in the company residency rules and the residency rules applicable to individuals.

340 (1972) 129 CLR 177; 72 ATC 4076; 3 ATR 105. The case determined that “control” in the context of “central management and control” had to be actual control - see above Part II B 3(d).

341 Hamilton, above n 15, para 2.240. Hamilton notes that a pragmatic approach to interpretation overcomes these conceptual difficulties.

D. The scope of the specific trust residency tests

As well as the two tests in s 95(1) of the 1936 Act there are also two areas where specific “residency” definitions are found: in respect of capital gains and in respect of the FSI rules. The scope of these specific residency definitions is set out in the following.

1 Resident trust for CGT purposes

The definition of “resident trust for CGT purposes” in s 995-1 was introduced as part of the Tax law Improvement Project’s rewrite of the capital gains tax provisions³⁴² and replaced the former definitions “resident trust estate” and “resident unit trust” in s 160H of the 1936 Act.³⁴³ The definition is important in the context of capital gains as a change in the residency of a trust can trigger the realisation of a capital gain or bring assets within the capital gain tax net.³⁴⁴

The “resident trust for CGT purposes” in s 995-1 of the 1997 Act (and adopted via s 6(1) of the 1936 Act) is merely a restatement of the tests contained in the former s 160H and adopts the same form of words of the “resident trust estate” definition in s 95(2)) of the 1936 Act. Thus, under this definition a trust, that is not a unit trust, is a resident trust for CGT purposes for an income year if, at any time during the income year the trustee is an Australian resident or the central management and control of the trust is in Australia.

A unit trust is a “resident trust for CGT purposes” for an income year if, at any time during the income year either:

342 The definition was introduced by *Tax Law Improvement Act (No1) 1998* (Cth).

343 These two definitions were introduced to define for the purposes of the capital gain provisions (Part IIIA of the 1936 Act) to define the scope of Division 2 of Part IIIA (which set out the general rules for determining acquisition and disposals of assets). The definitions ensured that the rules applied to assets, wherever situated, owned by residents and to “taxable Australian assets” owned by non-residents – see Explanatory Memorandum, Income Tax Assessment (Capital Gains) Bill 1986 (Cth), 28. The former definition of “taxable Australian assets” contained in s 160T encompassed major asset such as land, buildings, and in particular interest in a resident trust estate or 10 percent or more of the beneficial ownership of a resident unit trust.

344 1997 Act s 104-170 (CGT Event 12 – a trust ceases to be a resident) and 136-45 (a trust becomes a resident).

- any property of the trust is situated in Australia or the trust carries on a business in Australia; and either the central management and control of the trust is in Australia or
- Australian residents held more than 50% of the beneficial interests in the income or property of the trust.

This test is similar to the “resident unit trust” definitions in Divisions 6B and 6C of Part III of the 1936 Act (discussed previously in Part II C 1(B)(ii)). The term “property” is not defined in relation to this definition, but its sense can be obtained from the numerous division/part specific definitions through the 1936 Act.³⁴⁵ For example, as mentioned previously, s 102D of the 1936 Act defines the term widely to include a chose in action and “any estate, interest, right or power, whether at law or in equity, in or over property”. The term “beneficial interests” is also not defined. In the absence of any provision for tracing the term may be restricted to direct interests (entitlement) to the income or property of the trust.

This definition is also used in venture capital provisions for the purposes of the definition of a “resident investment vehicle” in the 1997 Act s 118-510.³⁴⁶ The venture capital provision in Sub-division 118G of the 1997 Act were aimed at excluding from income capital gains derived by non-resident venture capital entities (eg United States pension fund) where the gain arose from the disposal of venture capital equity in a resident investment vehicle in Australia.³⁴⁷ Although not expressly stated, the “resident investment vehicle” definition is used to confine the scope of the exemption to specific venture capital investments.

A “resident investment vehicle” is a “resident trust for CGT purposes” with fixed entitlements to all of the income and capital or a company that is an Australian resident.³⁴⁸ However, the total value of the investment, and the assets of the trust or company (including value of associated entities assets) must not be more than \$50,000,000 just before the venture capital is acquired and the primary activity of the company or trust is not property development or land ownership.

345 See, eg, 1936 Act ss 27A(1), 47A(21), 82KH(1), 100A(13), 102A(1), 102AA(1), 102AAB, 102D(1), 102M, 121F, 136AA(1) and 343.

346 The definition in s 118-510 of the 1997 Act was inserted by *New Business Tax System (Capital Gains Tax) Act 1999* (Cth) with effect from 10 December 1999.

347 Explanatory Memorandum, *New Business Tax System (Capital Gains Tax) Bill 1999* (Cth), 67.

348 1997 Act s 118-510.

In summary, the “resident trust for CGT purposes” definition for trusts other than unit trusts is the same as the principal definition in s 95(2) of the 1936 Act. For unit trusts the definition involves specific elements such as “50% of the beneficial interests in the income or property of the trust”.

2 FSI rules - “resident trust” and “Australian trust” definitions

The second area where specific residency definitions are used is in the FSI rules (ie, in transferor trust, CFC and FIF rules) in the 1936 Act. As mentioned previously, these rules tax residents on an accrual basis in respect of lowly taxed or untaxed foreign income (usually passive) earned by non resident trusts in which the residents are beneficiaries or have transferred value.

For the purposes of the transferor trust rules in Division 6AAA of Part III of the 1936 Act a trust is a “resident trust estate” if a resident trust under Division 6 of Part III of the 1936 Act, a corporate unit or public trading trust, or a “Part IX eligible entity” (ie, an eligible approved deposit fund (ADF), an eligible superannuation fund or a pooled superannuation trust³⁴⁹ (PST)).³⁵⁰ An “Australian trust” is for the purpose of the transferor trust measures in s 102AAB of the 1936 Act treated as having the same meaning as in Part X of the 1936.

Thus, in respect of the CFC rules, a trust is defined to be an “Australian trust” at test time if at any time in the 12 months preceding the test time the trustee of the trust was a “Part X Australian resident” or the central management and control of the trust was in Australia.³⁵¹ As discussed previously (in Part II C 2(a)) a “Part X Australian resident” is defined to be an entity that is a resident in terms of s 6 of the 1936 Act.³⁵² As the residency of a trust is not determined directly under s 6 of the 1936 Act a trust cannot be a “Part X Australian resident.” Alternatively the trust will be an “Australian trust” if it is a “corporate unit trust” or is a “public trading trust” under Divisions 6B and 6C of Part III of the 1936 Act, respectively.

349 1936 Act s 267.

350 1936 Act s 102AAB.

351 1936 Act s 338. Generally an “Australian trust” is defined in s 995-1 of 1997 as having the same meaning as in Part X of the 1936.

352 1936 Act s 317. An entity cannot be a “Part X Australian resident” if it is an entity that is a resident in both contracting states under a DTA (in force), and it is deemed for the purposes of that DTA to be resident in the foreign state.

Under the FIF rules, a trust will be an “Australian trust” at test time, if at any time in the 12 months preceding the test time the trustee of the trust was a resident or the central management and control of the trust was in Australia.³⁵³ Alternatively the trust will be an “Australian trust” if it is a “corporate unit trust” and a “resident unit trust” in Division 6B of Part III of the 1936 Act or is a “public trading trust” and a “resident unit trust” in Division 6C of Part III of the 1936 Act. As a “Part XI Australian resident” is similarly defined to be a resident in terms of s 6 of the 1936 Act,³⁵⁴ a trust cannot be a “Part XI Australian resident” as residency is determined under s 95(2) of the 1936 Act.

In summary, the scope of FSI specific residency rules is determined by the scope of the residency rules upon which they rely (ie the trust residency definitions in s 95(2) and in Divisions 6B and 6C of Part III of the 1936 Act).

3 *Summary*

Thus, specialised residency rules for trusts exist in two specific policy areas: in respect of the capital gains tax rules and in respect of the FSI rules. The “resident trust for CGT purposes” definition for trusts other than unit trusts is the same as the principal definition in s 95(2) of the 1936 Act. For unit trusts the capital gains definition involves specific elements such as “50% of the beneficial interests in the income or property of the trust”. The FSI rules rely on definitions in s 95(2) and in Divisions 6B and 6C of Part III of the 1936 Act. The final step is to determine the extent to which the trust residency definitions are impacted by DTAs.

E. Application of DTAs

Although double taxation can occur where trusts are found to be resident in two jurisdictions,³⁵⁵ the impact on DTAs appears to be negligible as Australia’s DTAs generally do not contain express residency tie breaker tests for trusts and there is no

353 1936 Act s 473.

354 1936 Act s 470. An entity cannot be a “Part XI Australian resident” if it is an entity that is a resident in both contracting states under a DTA (in force), and it is deemed for the purposes of that DTA to be resident in the foreign state.

355 Arnold, above n 195, 23, notes that “. . . problems also can arise under the laws of some countries in determining the residence of trusts . . . especially . . . when the country of organisation, the country of management, the country where the grantor or settlor is located, and the country where the beneficiaries are located are all different.”

specific tie-breaker clause in the 2003 OECD Model Convention. In fact the only DTAs that mention trusts are the Papua New Guinea, Canadian and the United States DTAs.

The Papua New Guinea DTA merely states that if a trust is resident in both states it is deemed not to be resident in either state.³⁵⁶ The Canadian and the United States DTAs extend the meaning of person to include “an estate” and “a trust”.³⁵⁷ As the residency of a trust in Canada is determined by the residence of the trustee³⁵⁸ the tie breaker tests in Article 4 of the DTA appear to apply to resolve double tax issues.

The United States DTA, however, does not provide a tie-breaker test. Instead, Articles 4(a)(iv) and (b)(iii) of the DTA defines the limited extent to which “an estate of a deceased individual or a trust” (other than a charitable fund or superannuation trust) will be a resident of Australia or will be a resident of the United States for the purposes of the DTA, respectively. An estate or trust is not generally a resident, but will be to the extent the income is subject to tax in Australia or the United States as the income of a resident estate or trust.³⁵⁹ Given this limited recognition there is little scope for double taxation and no need for a tie-breaker test under the DTA.

There are two possible reasons for the general absence of a residency tie-breaker test for trusts in the OECD Model Convention.³⁶⁰ First, as many countries do not have a domestic regime for taxing trusts, there is little reason for determining the allocation of taxing rights. Secondly, although trusts are created in circumstances of inheritance and

356 Papua New Guinea DTA, art 4(5).

357 Articles 3(1)(d) and 3(1)(a) respectively. The United States limits the estates to “an estate of a deceased individual”, which is consistent with the United States Model Convention - see Vogel, above n 168, 170 and 234.

358 *McLeod v Minister of Customs and Excise* (1926) 1 DTC 85 cited in Kroft, above n 249, 1:35.

359 The estate or trust will also be treated as an Australian or United States resident in respect of exempt provided, (i) in the case of Australia, the income exemption solely arose it was subject to United States tax; or (ii) in the case of the United States, the income was not so exempt because the beneficiary was not a United States person – art 4(1)(a)(iv) and (b)(iii).

Also, to overcome an argument that under art 7(1) non-resident beneficiaries of a trust deriving business profits through a trust could escape liability in Australia as the beneficiary did not have a permanent establishment, s 3(11) of the *International Tax Agreements Act 1953* (Cth) was inserted in 1984 to deem the beneficiaries to have a permanent establishment and all post 1994 DTAs included an specific sub article to serve a similar purpose– see Treasurer, ‘Taxation of foreign beneficiaries of Australian business trusts’ (Press Release, 19 August 1984) and Magney (1994), above n 172, 75. The deeming provision appears in arts 5(7) (Singapore), 7(7) (1995 New Zealand), 7(8) (Malaysia, Papua New Guinea, Thailand, Sri Lanka, Fiji, Kiribati, Poland, Indonesia, Vietnam, Spain, Czech, Taipei, South Africa, Slovak, Argentine, Romanian, 2002 Canada), 7(9) (Austria, China, Hungary, India, 2002 United States), and via note in most recent DTAs (2003 United Kingdom, Mexico, and Russia).

360 However, at the OECD’s 2001 Global Forum on Taxation dealing with Trusts at least one delegate suggested that the trust could be the relevant ‘person’ for treaty purposes rather than the trustee.

charitable bequests, the OECD Model Convention does not deal with double taxation arising from inheritance or gift taxes.³⁶¹

As trustees can be companies or individuals, it is possible that the tie breaker tests in Article 4 could apply to trustees, particularly as some states have thought it necessary to expressly exclude or limit the extent to which the income of trusts are covered by the DTAs.³⁶² Conversely, it is argued that the Model Convention does not apply to trustees as the tie breaker test can only determine the primary residency of the trustee in the trustee's own right, not in terms of the trust.³⁶³

On balance, the prevailing view is that residency of a trustee is not generally within the scope of the DTA tie-breaker tests.³⁶⁴

F. Summary

Unlike companies, the residency tests for trusts are restricted in operation to the specific Division or Part of the Act in which they are used. Thus, the s 95(2) of the 1936 Act trust residency definitions operate for the purposes of Division 6 of the 1936 Act, the capital gain definitions operate within for the purposes of ss 104-170 and 138-45 of the 1997 Act, while the FSI definitions operate within Division 6AA of Part III, Part X and Part XI of the 1936 Act. All these definitions draw upon company residency tests (eg

361 Timothy J Lyons, 'Introduction', Lyons above n 253, Introduction - 30.

362 John Prebble, 'Accumulation trusts and double tax conventions' [2001] *British Tax Review* 69, 71. It is argued at a number of levels. First, where the definition of a "person" does not expressly nominate trusts, a trust with multiple trustees could be "a body of persons" in that context. Second, as the trustee is "liable to tax" in respect of income accumulated, and in respect of income of beneficiaries that have a legal disability or are non-resident, then under Article 4(1) of the breaker test prima facie a trustee is a resident as they are liable to tax on income from all sources. However, where the resident beneficiary is presently entitled and not subject to a legal disability, the trust is a transparent entity (like a partnership) and excluded from the scope of Article 4 (see 2003 OECD Commentary on Article 4(1), para 8.4).

363 Robert Venables, *Non-resident trusts* (5th ed, 1993), 6.1.2 cited in Prebble (2001), *ibid*. There are a number of reasons. First, the tie-breaker criteria for individuals ("availability of a permanent home", "personal and economic relations", "habitual abode" and "nationality" tests) set out in Article 4(2) cannot be applied to a person in their capacity of a trustee as a trustee in that capacity does not satisfy any of the tests (John Avery Jones, et al, 'The treatment of trusts under the OECD Model Convention - II' [1989] *British Tax Review* 65, 67). Second, Article 3 of the OECD Model Convention only defines persons and companies in their own right, not in the role of a trustee (Kroft, above n 249, 1:38).

364 There have been attempts to ensure recognition of trusts in civil jurisdictions through the *Hague Convention on the Law Applicable to Trusts and Their Regulation* (1984), which applies trusts created voluntarily and evidenced in writing. The Convention seeks to introduce conflict of laws principles and requires states to recognise foreign trusts – see further Amanda Hardy, 'United Kingdom' in Lyons, above n 253, United Kingdom 13 and 14 and Ross Fraser and John Wood, *Tolley's Taxation of Offshore Trusts and Funds* (2ed, 1996), 4.

“central management and control”) or utilise some of the specific company residency tests (eg, the definition of an “Australian trust” adopts the definitions operative under Divisions 6B and 6C of Part III of the 1936 Act). However, unlike companies and individuals, the residency of dual resident trusts is not resolved under the DTA tie-breaker tests.

Having reviewed the scope of the residency rules applying to trusts, the next step is to explore the main thesis, ie "are the rules equitable, efficient, and simple" and "do the rules prevent tax avoidance”?

VII. Evaluating the effectiveness of the residency rules for trusts

The purpose of this Part is to explore whether the trust residency rules fail, in their practical application, to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance. The evaluation will be undertaken by illustrating circumstances where the law struggles to satisfy each of the evaluative criteria. As in respect of individual and company residency rules, the evaluative criteria is addressed by first exploring the equity objective before examining (in order) the efficiency, simplicity and the prevention of tax avoidance criteria. As many of the tests used have already been evaluated against these criteria in the company context, to avoid duplication in text and analysis it is proposed to discuss them in the context of the more relevant evaluative criteria only, with a passing reference being made to the other shortcomings.

A. Equity

In determining compliance with the equity objective, the following discussion will highlight where trustees in similar circumstances are not being taxed similarly (horizontal inequity). The horizontal inequity principally arises as a result of the vast number of “fact and circumstance” trust residency tests being used, for example:

- Division 6 trust residency definition in s 95(2) of the 1936 Act (the “central management and control” and residency of trustee tests);

- non-unit trust capital gains residency definition of “resident trust for CGT purposes” (the above s 95(2) tests);
- unit trust capital gains residency definition of “resident trust for CGT purposes” (the “carries on business in Australia”, “central management and control” and “beneficial interests” tests);
- transferor trust residency definition of “resident trust estate” (the above s 95(2) definitions);
- CFC trust residency definition of “Australian trust” (the “central management and control” and residency of trustee elements and the “carries on business”, “central management and control” and “beneficial interest” elements in the Divisions 6B and 6C of Part III of the 1936 Act tests); and
- FIF trust residency definition of “Australian trust” (the same elements as CFC test).

As under all these tests a trustee, in light of their factual circumstances, determines whether they satisfy one of these tests. As discussed previously (eg see Part III A 1), in common with other factual tests, a finding of residency could turn on a minor variation in a trustee’s circumstances or the management and control of the trust or, hypothetically, even on a difference in a single fact. As horizontal equity is found where trusts in similar circumstances are taxed similarly, the individual factual nature of these tests means that in application they fail to deliver horizontal equity.

B. Efficiency (Neutrality)

In light of the discussion in Chapter 2, the efficiency (neutrality) objective is satisfied if the rules relating to residency of trusts do give rise to distortions such as a trustee being taxed differently due to the market in which the taxpayer operates (eg physical or electronic). As with the residency rules for individuals, the residency rules for trusts apply the same tests to persons regardless of their mode of conducting business. However, as discussed in Part VII D, these rules are able to be manipulated to minimise or avoid tax. Therefore, there is a lack of neutrality as a result of the distortion caused by or flowing from tax avoidance. Thus, they are not efficient as distortions arise from tax avoidance through manipulation of the rules.

C Simplicity

In determining whether the residency rules for trusts meet the simplicity objective, the following discussion will highlight the extent to which the residency rules in application do not satisfy the indicators of simplicity, that is, they are predictable, proportional, consistent, do not impose high compliance burdens, are easy to administer, and clear. The extent to which problems are identified as arising under the various evaluative elements, will determine the extent to which the rules will be considered to have failed the simplicity objective in that circumstance. The evaluation will follow the order of evaluative elements as set out above, but will only address those elements that are relevant.

1 Predictability

The first element for judging simplicity is to determine whether in applying the residency rules for trusts, the results are predictable (ie it is easy to understand a rule's intended and actual scope). As discussed in the context of the company residency rules (Part III C 1), the principal factor that influences predictability of the residency rules for trusts is that a trust's residency depends upon its individual factual circumstances. As listed above under the equity evaluative criterion (Part V A) there exists a wide range of fact and circumstances tests. As the outcome under the residency tests can turn on a single fact, the outcome in many circumstances is difficult to predict.

2 Proportional

The second element for judging simplicity of the trust residency rules is to determine whether the complexity of the residency rules is proportional to the complexity of the policy. If the law is more complex than the policy, then the law will fail this element of the simplicity criterion.

The policy underlying the trust residency rules in s 95(2) of the 1936 Act is to ensure that trusts are taxable on foreign source income.³⁶⁵ However, despite these fairly simple policy objectives the facts and circumstances approach adopted in the “central management and control” test, and to a lesser extent in the “voting power control” test

makes these rules more complex in application than the simple underlying policy. Thus, complexity arising from the fact and circumstances approach adopted in the tests is disproportional in general to the underlying policy and, in these circumstances, fails this element of the simplicity criterion.

3 Compliance burdens

The third element used for judging simplicity of the trust residency tests is to determine qualitatively the level of cost (the burden) imposed upon the company in complying with the law. If examples indicate that the compliance costs are high, the rules fail this element of the simplicity criterion.

As noted above in respect of the company residency rules, a trustee, in a self assessment environment must determine, in light of the factual circumstances of the trust or the trustee, whether it is a resident under the various tests contained in the 1936 Act. However, this process is complicated as the origins of the “central management and control” test lies in the common law, and its scope has been defined by a long line of often conflicting United Kingdom and Australian judicial decisions. Added to this a number of specific residency definitions (ie “resident trust for CGT purposes”, “resident trust estate” and “Australian trust”) and an array of interrelating rules arise. As the definitions interrelate the cost of making determinations of residency is probably less than under the company residency rules. However, given that most of the tests used to determine a trust’s residency status are fact and circumstances based, this approach is a major contributor to compliance costs for affected trusts.

4 Difficulty in administration

The fourth element for judging simplicity is to determine whether there are any administrative difficulties in applying the residency rules for trusts. As discussed above, there are administrative difficulties arising from the fact and circumstance basis of the central management and control test, due to the ATO making individual, subjective determinations in respect of issues such as whether the company has the requisite “central management and control”. This uncertainty and the case by case nature of the test mean that the ATO is unable to give simple broad pronouncements on how the law

365 See Explanatory Memorandum, Income Tax Assessment Amendment Bill (No 5) 1978 (Cth), 16.

operates. As discussed in Part III C 4, this uncertainty can impact adversely upon the necessary level of compliance in a self-assessing environment.³⁶⁶ Thus, it is obvious that the uncertain and subjective “central management and control” test would have difficulty satisfying the simplicity criterion. Similar difficulties arise in respect of all the fact and circumstance trust residency tests.

In summary, the requirement in trust residency tests to determine residency status by factual circumstances remains a major contributor to tax administration difficulties for the Commissioner.

5 Clarity

The final element for judging simplicity is to determine whether the law is expressed clearly. If the law is expressed unclearly, it will fail this element of simplicity.

As with the individual and company residency tests a lack of clarity arises where a trustee or a trust is resident for only part of the income year. This occurs where a non-resident trust becomes a resident or a trust with foreign trustees becomes a non-resident due to changes in its ownership or movements in its central management and control. In such circumstances it is uncertain whether all the foreign source income of the trust is assessed for the whole year or just the foreign source income earned after obtaining Australian residency. Thus, without clear start and end dates for residency, the trust residency test also fails the certainty criterion.

There are also conceptual problems in applying the “central management and control” test in respect of trusts, as trusts are not separate legal entities, but a set of obligations imposed in respect of specific property. A pragmatic approach to interpretation is the only way to overcome these conceptual difficulties.³⁶⁷ Thus, again a residency rule fails the certainty criterion.

366 A search of the word “resident” on the ATOIDS section of the ATO website (URL at <http://www.ato.gov.au> located on 28 April 2004) reveals that only 15 of the over 500 ATOIDS, issued between 2002 and 2004, related to trusts and only one dealt with the residency of a trust.

367 Hamilton, above n 15, para 2.240.

6 Summary

From the discussion above, the trust residency rules fail the elements that gauge simplicity. Specifically, as the outcome of most of the tests is determined by the individual facts and circumstances, the outcome in many circumstances is not predictable. Further the complexity arising from the facts and circumstances approach is disproportional in general to the underlying policy, is a major contributor to compliance costs for affected individuals and remains a major contributor to tax administration difficulties for the Commissioner. Thus, the residency rules relating to trusts fail the elements that gauge simplicity (ie they are not predictable, not proportional, are associated with the imposition of high compliance burdens, are difficult to administer, and are expressed unclearly).

D. Tax Avoidance

In determining compliance with the prevention of tax avoidance objective, the following discussion will identify the circumstances where in the application of the law there appear to be evasion or avoidance opportunities. It will first explore weaknesses in the two trust residency tests in s 95(2) of the 1936 Act, before examining the specific residency definitions.

1 The residency of the trustee test

As the rules for determining the residency of a trustee are determined by the residence of the trustee (that is, where the trustee is an individual or a company) then the rules import all the opportunities for avoidance already discussed in Chapters 2 and 3.³⁶⁸ It is not proposed to repeat that analysis, but it is evident that by importing the “residency” element (that is easy to manipulate) into the test, then the test in turn is easy to manipulate and fails the prevention of tax avoidance criterion.

2 Central management and control test

Similarly, as this is the same test used for companies then the test imports all the complexity and problems already discussed above. Again it is not proposed to repeat

³⁶⁸ Don Green and Mark Friezer, ‘Taxation of the Income of non-resident trusts: The Consultative Document proposals’ (1989) 6 *Australian Tax Forum* 41, 55.

that analysis, but it is evident that by importing rules that are easy to manipulate, then the test in turn is easy to manipulate and fails the prevention of tax avoidance criterion.

A further complication in the trust context is that it is more difficult to prove indirect control of the central management and control where the controller is the beneficiary and the control is exercised through informal arrangements, rather than through the control of shares of the corporate trustee. In these circumstances, the difficulty in being able to establish control further illustrates the weakness of this test in preventing tax avoidance.

3 Specific residency tests

The use of alternative trust residency definitions in the Act does not reduce the opportunities for tax avoidance. For example, as the non-unit trust capital gains residency definition of “resident trust for CGT purposes” and the transferor trust residency definition of “resident trust estate”³⁶⁹ adopts the “s 95(2) of 1936 Act” trust residency tests, the definitions are in turn as equally subject to manipulation.

Similarly, the “carries on business in Australia” and “central management and control” tests are adopted in the unit trust, capital gains, residency definition (a “resident trust for CGT purposes”) and in the CFC and FIF trust residency definitions of “Australian trust”. As a result of the import of these two tests (that are easy to manipulate) both the “resident trust for CGT purposes” and the “Australian trust” definitions are in turn easy to manipulate and fail the prevention of tax avoidance criterion.

4 Summary

From the discussion above, it is apparent that the two trust residency tests in s 95(2) of the 1936 Act and the specialised trust residency definitions fail to counter tax avoidance. The risk of avoidance can be traced to the importation of residency concepts (ie, “residence” of trustee and the “central management and control” tests) from both the individual and company residency rules.

³⁶⁹ 1936 Act Division 6AAA of Part III.

E. Summary of Part VII

From the above it is clear that the existing law for determining the residency of a trust is inadequate. The major weakness with the trust residency rules is the importation of the factual elements of the company and individual residency tests, which in certain situations, results in the tests in identified ways failing to satisfy the equity, efficiency simplicity and prevention of tax avoidance evaluative criteria. Given that the rules fail all of the criteria, there is no need to address any potential conflicts in the evaluative criteria.

Thus, to ensure that the trust residency rules do better meet the evaluative criteria it is clear that the rules need to be reformed. The potential reform options are the focus of the following Parts VIII and IX.

VIII. Exploring the sub-thesis - Models for reform of trust residency rules

A. Overview

In order to establish the sub-thesis that the domestic law can be modified within the jurisdictional framework to more closely meet the evaluative criteria, a two-step approach will be adopted. First, in Part VIII a review of the residency rules adopted domestically in a number of jurisdictions will be undertaken. As the “trust” is essentially a common law concept it does not exist in civil law countries such as France and Switzerland.³⁷⁰ Therefore, the range of comparative models is in the main limited to common law jurisdictions. Secondly, in Part IX, in light of the comparative analysis, a number of reforms options (that are within the jurisdictional limitations) are reviewed against the evaluative criteria in order to determine whether the proposed rules are more equitable, efficient, simple and more able to prevent tax avoidance.

370 See Jean-Marc Tirard, ‘France’, in Lyons, above n 253, France 1 and Ryser, ‘Switzerland’, in Lyon above n 253, Switzerland 16. In France, the *Civil Code* (FRA), Art 544 requires absolute disposals of property and forbidding the utilisation of uses. However, French law does recognise trust like structure as charitable foundations and Swiss law recognises foundations, fiduciary arrangements (fiducia).

B. Comparing specific residency rules applicable in other jurisdictions

There are two ways trusts appear to be taxed, either:

- the trust is taxed on all its income, with a deduction allowed for amounts paid to beneficiaries,³⁷¹ or
- the beneficiary is taxed on amounts vesting or applied for the beneficiaries' benefit³⁷² and the trustee is only taxed either on income accumulated in the trust,³⁷³ or where the trustee has responsibility for tax (ie the beneficiary is under a legal disability,³⁷⁴ or the trustee is the assignee of the beneficiary.)³⁷⁵

The method of taxation often determines whether the residency test relates to the trust or the trustee.

There is a range of criteria used in other jurisdictions to determine the residency of a trust. These include:

- the residency of the trustee;³⁷⁶

371 The trust is the taxable entity in:

United States - *Internal Revenue Code of 1986*, IRC §641-645. Under these sections trusts are taxed as individuals and tax is paid by the fiduciary (s) on the income, but a deduction is allowed for "distributable net income". Also see eg, Joseph Isenbergh, *International Taxation* (2000), 25-6 and Charles M Bruce, *United States Taxation of Foreign Trusts* (2000), 1, 21-42;

Canada - *Income Tax Act* RSC C 1985 ss 104(2) and 248(1). A trust is generally taxed as an individual, but where income accumulated taxable in hands of trustee it is "designated income" and subjected to a different rate of tax; and

Indonesia - *Law Number 10 Year 1994* (Indonesia) Article 2 (3)(c) treats an undivided estate as a unit, in lieu of those entitled to it.

372 *Taxes Consolidation Act 1997* (IRE) s 59. See John H Hickson, 'Ireland' in Lyons, above n 253.

373 Eg, *Income Tax Act 1994* (NZ) ss HH 1 to HH 8. The trustee only pays tax on trustee income, ie any income not "beneficiary income". "Beneficiary income" is trust income which vests absolutely or is paid or applied during the year or within 6 months after the end of that year. Also in Ireland a surcharge is imposed on amounts not distributed - *Taxes Consolidation Act 1997* (IRE) s 805.

374 Eg, *Income Tax Act 1994* (NZ) s HH 3A.

375 As the trustee is principally liable (*Income Tax Act 1961* (India) ss 160 and 161) residency is determined either as individual (182 days in 12 months, in current year was in India for more than 60 days and spent 365 days or more in India in the preceding 4 years - *Income Tax Act 1961* (India) s 6), a Hindu undivided family (management and control in India - s 6(2)) or company (formed and registered under *Companies Act 1956* (India) or controlled and management of its affairs is situated wholly in India) - see Aliff Fazelbhoj and Porus Kaka, 'India' in Lyons, above n 253.

In Japan the income of a trust can also be taxed in hands of the grantor - see Hideaki Sato, 'Japan' in Lyons, above n 253.

376 The residence of the trustee is used in:

Canada, at common law - *McLeod v Minister of Customs and Excise* (1926) 1 DTC 85 cited in Kroft, above n 249, 1:35;

- the residency of the settlor;³⁷⁷
- the residency of the beneficiary;³⁷⁸
- the location of property;³⁷⁹
- the place where the trust carries on business;³⁸⁰ or
- where the trust is administered³⁸¹ (managed) or controlled.³⁸²

As residency under all these tests (except the location of real property) is determined according to the individual fact and circumstances, the tests tend to fail the evaluative criteria in respect of simplicity and prevention of tax avoidance. It is not proposed to

Malaysia - *Income Tax Act 1967* (Malaysia) s 61(3). A trust is a non-resident if created by a person who is non-resident, income derived from foreign sources, administration outside Malaysia and half or more of the trustees are not residents of Malaysia and is a non-resident - see *Malaysian Master Tax Guide*, above n 254, 108-9;

South Africa - see David Clegg, 'South Africa' in Lyons, above n 253;

United Kingdom - for capital gains, trustees are deemed to be resident or ordinarily resident unless the general administration of the trust is ordinarily carried on outside the United Kingdom, the majority of trustees are not resident or ordinarily resident in Ireland - *Taxation of Chargeable Gains Act 1992* (UK) s 69(1); and

United States - A trust is a "United States person" (*Internal Revenue Code of 1986*, IRC § 7701(a)(30)) and hence subject to US worldwide tax if the trust is subject to the authority of the Court in the United States and the fiduciaries in control (ie power to make all substantial decisions of the trust (*Internal Revenue Code of 1986*, IRC §301.7701-7(d)(1)(ii))) of the trusts are United States persons See eg, Isenbergh (2000), above n 371, 25-6 and Bruce, above n 371, 1, 21-42.

377 The basis for determining residency of a trust in New Zealand is the residence of the settlor. For example, a non-resident trustee in receipt of non-New Zealand income may be treated as a resident if the settlor is a New Zealand resident. In these circumstances the resident settlor, is liable as an agent of the trusts for any income payable by the trustee - *Income Tax Act 1994* (NZ) s HH 4(3) and (4). Under s OB 1 and HH 1(1) a settlor is the person who directly or indirectly contributes value, provides services or makes property available, not the person who contributes a nominal amount.

Contrast this with Canada, where at common law residency of the settlor was irrelevant in determining residency of the trust - *Thibodeau Family Trust v The Queen* 78 DTC 6376.

However, in the United Kingdom trustees of testamentary trusts are deemed resident unless the settlor was not resident, ordinarily resident nor domiciled in United Kingdom at time of their death - *Finance Act 1989* (UK) s 110(2)(3). For income tax purposes, where there are resident and non-resident trustees, provided a trustee is resident, all the trustees are treated as resident if the settlor was resident, ordinarily resident or domicile in the United Kingdom at the time the trust was created or at a later time provided funds for the trust - *Finance Act 1989* (UK) s 110. This provision over rules *Dawson v IRC* [1988] STI 445, which found that if all the trustees are not residents, foreign income of the trust is not assessable. Also see Amanda Hardy, 'United Kingdom' in Lyons, above n 253.

378 Under Canadian common law residency of beneficiary was irrelevant in determining residency of the trust - *Thibodeau Family Trust v The Queen* 78 DTC 6376.

379 In Canada the place of business and location of property may be relevant in determining residency of the trust - Jack Bernstein, 'Residence of trusts for Canadian tax purposes' (1998) 52 *Bulletin for International Fiscal Documentation* 122, 124.

380 Ibid.

381 Ireland - Trustees are deemed to be resident or ordinarily resident unless the general administration is ordinarily carried on outside Ireland, and the majority of trustees are not resident or ordinarily resident in Ireland - *Taxes Consolidation Act 1997* (IRE), s 574. Similarly in the United Kingdom

382 Under Canadian common law "central management and control" was irrelevant in determining residency of the trust - *Thibodeau Family Trust v The Queen* 78 DTC 6376.

reexamine each against the evaluative criteria as the manner in which such tests fail the objective criteria has been discussed in detail previously.³⁸³

As well as these primary residency tests countries have adopted special purpose definitions.³⁸⁴ Therefore, as with the Australian specific purpose tests (see Part VI D), most of these tests rely on concepts already examined and it is not proposed to repeat that analysis.

C. Summary

The models of trust residency in use elsewhere in the world are merely variants of the tests adopted in Australia. Thus, they incorporate the defects identified in the analysis of the Australian tests and contravene the good tax law criteria. Therefore, the trust residency rules, which operate in other jurisdictions, offer no clear solutions and little guidance for reform.

IX. Reform options for trusts

A. Overview

In Part VII of the thesis it was established that Australia's current rules for determining the residency of a trust failed the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance. In order to explore the sub thesis, that the law can be modified within the jurisdictional framework to more closely meet the evaluative criteria, a review of residency models adopted in other jurisdictions was conducted in Part VIII. As the tests used internationally are modifications of concepts used in Australia no particular residency test satisfied all the evaluative criteria. Thus, the

383 The residency of the trustee (which has application to the residence of the settlor and beneficiary) was discussed in Part IV C 2, the "carries on business" was evaluated in Part III and where the trust is managed and controlled in Part IV C 3.

384 For example, Canada defines the residence of a qualifying environmental trust (*Income Tax Act* RSC C 1985 (Can) s 250 (7)), deems residency for part-year resident inter vivos trusts (*Income Tax Act* RSC C 1985 (Can) s 250 (6.1)) and imposes a residency requirement for the registration of certain mutual trusts and education trusts (*Income Tax Act* RSC C 1985 s 132(6)(b)). In the United States, as trusts are established under state laws a necessary requirement of residency in *Internal Revenue Code of 1986*, IRC § 7701(a)(30)) is that the trust must be subject to the authority of the Court in the United States.

purpose of this Part is to explore the approaches for modifying the existing rules such that they better meet the evaluative criteria.

As discussed adopted in Part V, the approach adopted for reform involves changing some of the existing tests from the facts and circumstance model to arbitrary number of day or specific criteria models (ie trading-off equity for simplicity and the prevention of tax avoidance).

B. Reform options

In the following, each of the trust residency rules will be reviewed to determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria.

1 The residency of the trustee test

(a) Evaluating options for reform

As noted in Part VII, the rules for determining the residency of a trustee are determined by the residence of the trustee (that is, where the trustee is an individual or a company) and consequently the rules import all the failings already discussed in Chapters 2 and 3.

It has been suggested that the test should be the residence of the settlor (as in New Zealand) as it is the true settlor who transfers value to the estate, not the manager (the trustee). The true settlor is the person on whose behalf the trustees operates.³⁸⁵ It is claimed that the use of a settlor overcomes problems of avoidance where the trustee is not a resident of Australia as the settlor or associates will tend to reside within the jurisdiction.³⁸⁶

However, despite the claims that the proposal reduces the scope for avoidance, the test merely substitutes a “settlor” for a “trustee” and thereby incorporates all the same

385 John Prebble, ‘Taxation of trusts with Australian resident trustees’ [2000] *British Tax Review* 653, 659.

386 *Ibid*, 660. This is similar to the “transferor” (ie an “attributable taxpayer”) under the Australian transferor trust measures – see 1936 Act s 102AAT.

problems associated with determining residency. It will also result in the jurisdictional scope being widened.

Another alternative to determining the residence a trustee was suggested in the context of the consultation on the entity tax proposals.³⁸⁷ In order to align the taxation of companies and trusts it was proposed that a test akin to incorporation could be introduced for trusts. The test was based upon the place the trust was “created”. Although formation would appear to be determined by objective tests, the “relationship” nature of trusts and the fact they are generally not registered would mean that formation would be determined on a factual basis.³⁸⁸

(b) *Finding the balance*

Both the substitution of a settlor and the adoption of a creation test do little to ensure that the domestic law of trust residency more closely meets the tax policy objectives. However, if the recommended reforms in respect of the individual residency tests (in Chapter III, Part V) and in respect of the company residency tests (in Part V of this Chapter) are adopted then the “residency of trustee” test will more closely meet the tax policy objectives, within the existing jurisdictional framework.

387 On the 13 August 1998 the Federal Government made an election proposal to tax trusts as companies (Australian Government, *Tax Reform, Not a New tax, a New Tax System* (1998)). This proposal was adopted by the Review of Business Taxation, which recommended the adoption of an entity tax regime whereby trusts, life insurers, co-operatives and limited partnerships were taxed as companies (A Tax System Redesigned, above n 42, sections 11, 12, 13, 16 and recommendations 6.7, 6.20, 6.21, 6.22, 6.23 and 18.6). The Government accepted these recommendations (Treasurer, – ‘The New Business Tax System’ (Press Release No 58, 21 September 1999) Attachment K and Treasurer, – ‘The New Business Tax System: Stage 2 Response’ (Press Release No 74, 11 November 1999)) and on 11 October 2000 *Exposure Draft: New Business Tax System (Entity Taxation) Bill 2000* a much modified proposal which only applied entity taxation to non-fixed trusts.

388 The creation of a trust has two elements: an agreement to the terms and conditions and the conveyance of legal title to the trust’s property. It is only valid if it complies with the law of where the act of declaring the trust took place (*lex loci actus*) or the proper law regulating the agreement (including formal requirements, capacity, validity and place of administration). The place of general administration is usually where the bulk of the assets are located (*Permanent Trustee Co (Canberra) Ltd v Permanent Trustee Co of New South Wales Ltd* (1969) 14 FLR 24) but for a single asset it is the jurisdiction of location (*lex situs*) of that asset (*Re Tyndall* [1913] SALR 39). Given these variants the place of formation can be difficult to determine. An example is the facts in *Lindsay v Miller* [1949] VLR 13. In this case the settlor was domiciled in Scotland, the deed drafted in Scotland, with one trustee living in China, another Melbourne and a third in Western Australia. The deed was executed in Scotland by a settlor and two of the trustees, with the third trustee executing it in Melbourne. The assets (shares in Victorian companies) were located in Melbourne as was the administration. The place of formation was Victoria. See Peter E Nygh, *Conflicts of Laws in Australia* (3rd ed, 1976), Ch 27 and JHC Morris (ed), *Dicey and Morris on the Conflict of Laws* (9th ed, 1973) 651-662.

2 Central management and control

As the “central management and control” test has been evaluated above (Part V B 2 (b)) the observations in this context are similar, that is, it is only by substituting the common law test with more objective statutory criteria that the test can be improved to better meet the tax policy objectives. However, this cannot be supported in the context of the sub-thesis as it would be a variation to the jurisdictional claim. Therefore, in this context the “central management and control” test cannot be reformed to better meet the tax policy objectives.

3 Specific residency tests

As discussed in Part VI D 1, the capital gain residency definitions (which operate for the purposes of ss 104-170 and 138-45 of the 1997 Act), and the FSI residency definitions (which operate within Division 6AA of Part III, Part X and Part XI of the 1936 Act) all draw upon company residency tests (eg “central management and control”) or utilise some of the specific company residency tests (eg, the definition of an “Australian trust” adopts the definitions operative under Divisions 6B and 6C of Part III of the 1936 Act). Therefore, if the recommended reforms in respect of the company residency tests (in Part V of this Chapter) are adopted then the specialised residency tests will more closely meet the essential tax policy objectives, within the existing jurisdictional framework.

C. Summary

In the above analysis each of the trust residency rules was examined to determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. As the trust rules rely heavily on the rules relating to individuals and companies it is through the improvement in these underlying concepts that the residency rules for trusts can be improved to better meet the essential tax policy objectives. Without change to the jurisdictional claim the trust rules cannot be directly altered to better meet the essential criteria.

X. Conclusion

A. The main thesis

The purpose of the analysis in Parts II, III, VI and VII of this Chapter was to establish the main thesis in respect of the residency rules applicable to companies and trusts, that is:

The law, as applying in the 1997 Act, is inadequate as the law fails in its practical application to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

In Part II of the Chapter, the scope of the residency rules for company residency was explored, and it was found that the existing law for determining the residency of a company is inadequate. Overall the rules fail in identified ways to satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criteria. The major weakness in the non-incorporation residence tests is the factual element of the tests, which in certain situations:

- results in horizontal inequity;
- gives rise the lack of simplicity; and
- leaves the rules open to manipulation.

Similarly, in Part VII it was established that existing law for determining the residency of a trust is inadequate. The major weakness with the trust residency rules is the importation of the factual elements of the company and individual residency tests, which in certain situations, results in the tests in identified ways failing to satisfy the equity, efficiency simplicity and prevention of tax avoidance evaluative criteria.

Thus, it has been established that residency rules applicable to companies and trusts in the 1997 Act are inadequate as the law embodying those rules fails in its practical application to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

B. The sub-thesis

The purpose of the analysis in Parts IV, V, VIII and IX of this Chapter was to establish the sub-thesis in respect of the residency rules applicable to companies and trusts, that is:

The domestic law can be modified within the jurisdictional framework to more closely meet the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

In the above Part V, each of the company residency rules was examined to determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. It has been recommended to repeal the "voting power test" and that the "central management and control" test be amended by restoring the "carries on business" element of the test. In main the changes recommended are only those minor changes which do not extensively modify the jurisdictional claim. These changes, combined with some technical alterations will result in the company residency rules in a minor way better meeting the evaluative criteria.

Similarly, in Part IX, each of the trust residency rules was examined to determine whether the rules can be modified, within the jurisdictional framework to better meet the evaluative criteria. As the trust rules rely heavily on the rules relating to individuals and companies it is only through the improvement in these underlying concepts can the residency rules for trusts be improved to better meet the essential tax policy objectives.

Thus, although not every company residency test is able to be amended, and any changes to the trust residency rules are reliant on changes to the individual and company residency rules, overall it has been established that residency rules applicable to companies in the 1997 Act, if modified within the jurisdictional framework as recommended, do more closely meet the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

Chapter 5

Source

I. Purpose of this Chapter

As noted in Chapter 1, among the primary objectives of this thesis is the examination and assessment of the adequacy of the rules of attachment. This Chapter focuses on the second means of attachment, source. The Chapter first evaluates whether the current approach to determining source of income for the purposes of the 1997 Act satisfies the "essential criteria" of a good tax law (equity, efficiency, simplicity and prevention of tax avoidance).

Integral to this analysis is the initial examination in Part II of the operation of the statutory source rules and the guiding principles emerging from the common law. Part II focuses on an overview of what is source, before exploring the scope of the law and principles of source in the context of personal exertion, income from business (including the taxation of capital gains), and income from property. The impact of DTAs will also be examined in the context of each income category. The Part II examination provides the necessary basis to enable the law of source to be reviewed against the evaluative criteria in Part III.

In addressing the sub-thesis Part IV explores the various options for reform through a review and evaluation of the domestic statutory source approaches adopted in New Zealand and the United States. However, as in Chapters 3 and 4, this latter analysis will be restricted to the domestic statutory source rules.

In light of this comparative study, Part V explores whether the current domestic approach to source can be reformed within current jurisdictional limitations, such that the law is more equitable, efficient, simple and more able to prevent tax avoidance. Finally, Part VI will draw together the conclusions and recommendations.

II. Exploring the main thesis – Scope of the law of source

Integral to the process of exploring the main thesis, it is first necessary to examine what is meant by the term “source” before exploring the scope of the law and principle underlying a finding of source.

A. *What is meant by source?*

As mentioned in Chapter 1 (Part I) there are at least three circumstances where the term “source” is used under Australia’s tax laws. First, the term “source” is used sometimes to describe the process of taxing income as it arises (usually through withholding), before it is paid over to the “person” who has derived the income (ie “taxation at the source”).¹ Thus, where a receipt is paid by Australian residents (or by non-residents who are carrying on business in Australia) to non-residents, the receipts are deemed to have an Australian origin regardless of the actual territorial source of the income. These withholding taxes override territorial source² and focus on the status of the payer.³

Secondly, the concept of “source” is more commonly used to refer to the “character” of the receipt (ie its characterisation). The characterisation of the receipt is the classification of receipts according to the nature of the activity that gave rise to the receipt, for example “income from business”, “income from property”, “income from personal service” (personal exertion) or “capital receipts”. Although the abolition of the income classification definitions in the 1997 Act may initially appear to have lessened the importance of such characterisation, the process is still important in a number of areas of domestic law (including the alienation of personal services income measures⁴ and income/capital determinations) and is crucial in determining the nature of a receipt (such as employment income, a royalty, interest, etc) for the purposes of the taxing rights allocated under Australia’s DTA’s. Thus, characterisation issues remain an

1 Piroška E Soos, ‘Taxation at the source and withholding in England, 1512 to 1640’ [1995] *British Tax Review* 49 and Piroška E Soos, *The Origins of Taxation at the Source in England* (1997).

2 FA Rollo, ‘Commentary: Source of income’ (Paper presented at the 10th *Taxation Institute of Australia’s New South Wales State Convention*, Sydney, 26-28 May 1978) 43, 52.

3 Roger Hamilton, Robert Deutsch and John Raneri, *Australian International Taxation* (October 2002), para 2.690.

4 1997 Act s 84-5(1).

essential element in determining “territorial” (geographic) origin of the income; its “source”.⁵

“Territorial” source is the third usage of the term “source” and refers to the place at which the income arises. The applicability of a particular territorial source rule can only be determined when the nature of the receipt is determined.⁶ For example, a different source rule will apply when a receipt is deemed to be a capital gain rather than when it is deemed to be a royalty.⁷ Unlike residency, source is not purely a matter of geography as the source of income depends upon how it is produced, where it is produced and who pays it.⁸

Although characterisation is an important issue, this Chapter will concentrate on the statutory law and judicial principles that underlie a determination of the territorial source of income. Thus, characterisation issues are outside the direct scope of the thesis as they are a preliminary classification step in the determination of source. However, as the source of income is dependent on classification issues they will be highlighted, but not necessarily resolved. Similarly, where issues associated with the withholding (origin) rules arise, they will be addressed only briefly. As origin rules merely compel the withholding of tax due to the location of the payer, they do not determine source and, therefore are also outside the direct scope of the thesis.

B. Overview of the law of source

As discussed in Chapter 1, Australia used a territorial (source) tax system as the primary method for determining liability for income tax until the introduction of the residency concept in 1930. Subsequently, source taxation applied to non-residents that derive

5 The most common usage of the term ‘source’ is in respect of characterisation and territorial source - see Jinyan Li, ‘Rethinking Canada’s source rules in the age of electronic commerce: Part 1’ (1999) 47 *Canadian Tax Journal* 1077, 1080.

6 Bill Cannon, ‘A practical look at e-commerce and source rules’ (Paper presented at the 4th World Tax Conference, Sydney, 27 February 2004), 7 and Bill Cannon and Peter Edmundson, ‘A practical look at source rules issues’ (Paper presented at the Taxation Institute of Australia’s International Masterclass, Sydney, 22 September 2004), 1.

7 The importance of characterisation is recognised by the ATO (Australian Taxation Office, Commonwealth, *Taxation and the Internet: Second Report* (1999), 113-26 (ATO’s second Internet Report)) and the OECD (by establishing a Technical Advisory Group (TAG) on Treaty Characterization of E-Commerce Payments).

8 Robert Couzin, *Corporate Residence and International Taxation* (2002), 6.

ordinary or statutory income from sources in Australia.⁹ The Asprey Committee noted that:

[t]he justification for imposing income tax on non-residents on the basis of origin in Australia rests on the 'benefit' principle, [that is,] the non-resident's income has been generated by economic activity conducted under the protection of the country of origin and relying on facilities provided, at least in part, at public expense.¹⁰

Section 995-1 of the 1997 Act defines "Australian source" in terms of:

*ordinary income or *statutory income has an Australian source if, and only if, it is *derived from a source in Australia for the purposes of the 1936 Act.

However, the word "source" is not defined in the 1936 Act. What the s 995-1 definition incorporates into the 1997 Act is a number of statutory rules in the 1936 Act and the common law principles that have been used by the courts in determining the source of income under the 1936 Act.

The statutory rules in the 1936 Act are ad hoc rules, not governed by any general principles. The rules deem an Australian source for dividends,¹¹ interest payments (where the monies are secured by mortgage on an Australian property),¹² certain royalty payments,¹³ certain natural resource payments,¹⁴ business income where business is carried on partly in and partly out of Australia,¹⁵ overseas shipping payments¹⁶ and certain insurance premiums.¹⁷ There are also a series of exempt income rules relating to income sourced in a specified Territory.¹⁸ The genesis of many of these rules is the 1936 Act and, in some cases, the 1915 Act and earlier State Acts.¹⁹

9 1997 Act ss 6-5 (3) and 6-10 (5).

10 Taxation Review Committee, Commonwealth, *Full Report* (1975) (Asprey Report), 264. Asprey concludes "[t]his is equally true whether the income has been produced by the activity of the non-resident himself, as by manufacturing operations in Australia conducted by him through a branch, or by resident who pays what would otherwise have been his profit to the non-resident, by way of interest or royalties."

11 1936 Act s 44 (1)(b).

12 1936 Act s 25(2).

13 1936 Act s 6C.

14 1936 Act s 6CA.

15 1936 Act Division 2, Subdivision C of Part III.

16 1936 Act Division 12 of Part III.

17 1936 Act Division 15 of Part III.

18 1936 Act ss 24F, 24G and s 24J to 24M in Div 1A of Part III. Division 1A exempts Norfolk Island residents from tax on income derived from sources in and outside of the Territory (including

As well as the statutory source rules there are statutory withholding tax rules that impose tax on payments (interest, dividends and royalties) that have an Australian origin rather than source.²⁰ In fact, many of Australia's statutory source rules have an "origin" flavour as they deem a fixed percentage of the receipts to have an Australian source.²¹

As these statutory provisions do not cover all situations, the common law provides the basis for determining source in other situations. Essentially, at common law, the word "source" refers to the origins of the income. Issacs J in the High Court decision in *Nathan v Federal Commissioner of Taxation*²² stated that:

The legislature in using the word 'source' meant, not a legal concept, but something which a practical man would regard as a real source of income. Legal concepts must, of course, enter into the question when we have to consider to whom a given source belongs. But the ascertainment of the actual source of a given income is a practical hard matter of fact.

This view has wide acceptance.²³ Further:

[t]he cases demonstrate that there is no universal or absolute rule which can be applied to determine the source of income. It is a matter of judgment and relative weight in each case to determine the various factors to be taken into account in reaching the conclusion as to source of income.²⁴

Australia). The purpose of the Division 1A is to safeguard against exploitation of the tax exempt status of Territory residents by persons not resident in the Territory - Explanatory Memorandum, Income Tax Assessment Act (No 4) 1973 (Cth), 7.

19 For example the ship charterer source rules were introduced into New South Wales in 1895 by *The Land and Income Taxation Assessment Act 1895* (NSW) s 24 and in Victoria in 1896 by the *Income Tax Act 1896* (Vic) s 18. The rules in NSW were adopted from the *The Land and Income Tax Assessment Act 1891* (NZ) Schedule C (1) – FH Salusbury and W Newberry, *Salusbury and Newberry's Land and Income Tax Assessment Act of 1895* (1896), 86.

20 1936 Act Part III, Div 11A.

21 Asprey Report, above n 10, 262. For example 1936 Act Division 12 of Part III.

22 (1918) 25 CLR 183, 189; R & McG 14, 15. Also Higgins J in *Dickson (as Public Officer of Adelong Gold estates, No Liability) The Commissioner of Taxation (NSW)* (1925) 36 CLR 489, 501; R & McG 168,169 noted "[n]ow the word 'source' is not technical; it has to be interpreted according to its ordinary use in common language. The original idea, I suppose, is that of a stream issuing from a mountain; but the metaphorical use of the word is very frequent."

23 *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601, 620; 85 ATC 4374, 4390. In *Federal Commissioner of Taxation v Mitchum* (1965) 113 CLR 401, 407; 13 ATD 497, 501; 9 AITR 559, 567 (Barwick CJ) noted "[t]he conclusion as to the source of income for the purposes of the Act is a conclusion of fact. There is no statutory definition of "source" to be applied, the matter being judged as one of practical reality. In each case, the relative weight to be given to the various factors which can be taken into consideration is to be determined by the tribunal entitled draw the ultimate conclusion as to source. In my opinion, there are no presumptions and no rules of law which require that question be resolved in any particular sense."

24 *Spotless Services Ltd v Federal Commissioner of Taxation* (1993) 25 ATR 344, 359; 93 ATC 4397, 4410 (Lockhart J).

Thus, the source of income may consist of several factors, and a determination of source for tax purposes may depend on which of the factors is dominant.²⁵ As a result the outcome of many cases in this area will turn on their particular facts, appearing in some circumstances to give rise to conflicting results. In summary, it is a misnomer to use the words “rule” or “law” in respect of determinations of source at common law; rather the cases lay down principles that can be used to ascertain where source lies as a matter of fact.²⁶

Finally, in the source context the impact of DTAs is crucial. The allocation of taxing rights under all Australian DTAs overrides the source of income as determined under Australia’s domestic law. To ensure that the income “allocated” by the DTA is taxable in Australia most of Australia’s DTAs contain a unique “Source of Income” Article.²⁷ It deems income, for which taxing rights have been allocated under a DTA, to be sourced in the country allocated the taxing right regardless of its territorial source under the domestic law.²⁸

In light of the above, in order to evaluate source against the evaluative criteria, it is important to fully explore the scope of key statutory source and origin rules, the principles at common law and most importantly, the impact of DTAs. The examination will explore the scope of these “rules” under the following three headings: income from

25 *Commissioner of Taxation (NSW) v Cam & Sons Ltd* (1936) (1936) 36 SR (NSW) 544; 4 ATD 32.

26 Tom Magney, ‘Some aspects of source of income’ (1997) *Taxation Institute of Australia 1997-98 Convention Papers* 1, 17 that often judges, having paid lip service to *Nathan* tend to search for legal concepts and rules to determine the matter. In *Tariff Reinsurance Ltd v Commissioner of Taxation (Vic)* (1938) 59 CLR 194, 208; 1 AITR 281, 286; 4 ATD 498, 503, Rich J noted “. . . a hard practical matter of fact . . . means, I suppose, that a case must be decided on its own circumstances, and that services, pretexts, devices and other unrealities, however fair . . . are not to stand in the way of the court charged with the duty of deciding these questions. But it does not . . . mean that the court is to treat contracts agreements and other acts, matters and things existing in the law as having no significance.”

27 To deal with source limitations under the 1936 and 1997 Acts (ie 1936 Act s 23(r)), all but two of Australia’s DTAs (being Japan and Germany) contain a “Source of Income” Article. The Article deems income, profits or gains derived by a non-resident which, under any one or more of Articles 6 to 8 and 10 to 19 and 21, taxed in Australia shall for the purposes of Australian law (and Article 24) to be income from sources in Australia – see Tom Magney, *Australia’s Double Tax Agreements: A Critical Appraisal of Key Issues* (1994), 42. The deemed source rule is sometimes inserted indirectly, either in the *International Tax Agreements Act 1953* (Cth) (eg ss 11S(5) and 11ZF(3) for China and Taiwan respectively) or in the notes to the protocol (eg Netherlands and Russia).

28 John Avery Jones, et al, ‘Tax treaty problems relating to source’ [1998] *British Tax Review* 222, 224 and 232; and Magney (1994), *ibid*, 42-3.

personal exertion, income from business (including the taxation of capital gains), and income from property.²⁹

C. Income from personal exertion

1 Overview

There are no statutory source rules in relation to income from personal service under the 1936 or 1997 Acts. Therefore, the principles applicable are derived from the common law. There are several factors that determine the source of personal exertion income, being the places of “. . . negotiating and obtaining the contract of employment, in performing the stipulated services, and in obtaining payment.”³⁰ If there is nothing special about the contract or in the payment, then the all important factor is where the work is done.³¹

However, it appears from the case law that different weightings of facts are applied in determining the source of income from employment (dependent personal services) under the common law to those applied in determining the source of income from a personal service business or profession (independent personal services).³² Given this apparent difference, the scope of each category of personal service will be examined separately, starting with dependent personal services.

29 Magney (1994), *ibid*, 3 notes that the DTA distributive rules can be similarly classified into rules referring to:

- income from certain activities (business (art 7), employment (art 15), government services (19) and agriculture and mining (art 6));
- income from certain assets (dividends (art 10), interest (art 11), royalties (art 12) and income from immovable property (art 6));
- capital gains (arts 13 and 22);
- status of the taxpayer (directors (art 16), artistes and sportsmen (art 17), pensions (art 18) and students (art 20); and
- income not dealt with under other categories (art 21).

30 *Commissioner of Taxation (NSW) v Cam & Sons Ltd* (Jordon CJ) (1936) 36 SR (NSW) 544, 548; 4 ATD 32, 33.

31 In *Cam* the men were employed at shipside on the morning of sailing, spent the days fishing outside territorial waters and they were paid off immediately after the ship berthed after the voyage.

32 See Asprey Report, above n 10, 275-6.

2 Dependent Personal Services (Income from employment)

The process for determining the source of employment income is explored by first looking at common law before looking at the impact of DTAs.

(a) *The common law factors which determine source*

The source of income from dependent personal service is either the place where services are rendered or the place where payment for services is made.³³ A number of pre 1950's court decisions found that the source of the income was a jurisdiction other than the one in which the employee performed the services. In these cases the place of payment was crucial (due to the nature of the payments³⁴ or the terms of the contract³⁵).³⁶

33 *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, 405; 7 AITR 76, 82; 11 ATD 288, 293 (Williams J). However, as noted above, place of negotiating and obtaining the contract is another factor not in question in *French*.

34 *Richard Teece v Commissioner of Taxation* [1914] R & McG, NSW Court of Review Decisions (1927), 19 (Murray DCJ) found that salary received while the taxpayer was on leave of absence for nine months in London was from sources in New South Wales as it "... is paid in consideration of services which the officer has rendered and will render in the future ... and ... he is still receiving ... income because it was the reward or the price of services rendered in the taxing country." Cf *Robertson v Federal Commissioner of Taxation* (1937) 57 CLR 147; 1 AITR 152; 4 ATD 355, where a governing director of a Victorian company, who abroad for two years, had his salary treated as arising from sources outside Australia (due to the Commissioner incorrectly conceding its source was outside Australia) - see *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, 405; 7 AITR 76, 79; 11 ATD 288, 290 (Dixon CJ) and *Case 40* (1928) 2 DITBR 43, where a director on a trip to America, England and the Continent was able to show he was actively engaged in the day to day business affairs of the company, thus a proportional part of his salary was found to have a source outside Australia.

35 In *Hall v Federal Commissioner of Taxation* (1950) 5 AITR 450; 9 ATD 161, Herron J, in distinguishing the similar fact case of *Federal Commissioner of Taxation v Miller* (1946) 73 CLR 93; 8 ATD 146; 3 AITR 333 on the basis that it involved residency, found that a taxpayer employed as a fourth engineer by the United States Army and serving 5 months in Milne Bay in 1944-5 was taxable on the income as it was sourced in Australia. "The source of the appellant's income was the contract under which the work was performed ... It was the contract which entitled him to be paid the moneys, and not the place where the work was actually performed" Herron J relied upon the English decisions of *Bennett v Marshall* (1938) 1 KB 591; 22 TC 73, *Colquhoun v Brooks* (1889) 14 AC 493 and *Foulsham v Pickles* (1925) AC 458. He concluded that the test for ascertaining the source of income is to look at the place where the income comes into the employee. Thus, the source was the place the contract was entered into, his home port, the place where his money was paid to his wife, the place where he was to be returned.

36 One case was decided due to limitations on the scope of the taxing jurisdiction - see *Kingsford-Smith v Commissioner of Taxation* [1924] R & McG NSW Court of Review Decisions (1927), 111. The Court found that salary earned by an Australian naval officer on Commonwealth naval vessel in New South Wales waters was not found to be sourced in New South Wales as the vessel was a "public vessel belonging to a friendly power" and therefore does not fall within the local jurisdiction (applying the principles in *Exchange v McFaddon* [1812] 7 Cranch 116).

Despite these early cases, the courts have since found that the place where personal services are rendered (where the personal service takes place) is the determinative factor in finding source³⁷ (eg *Commissioner of Taxation (NSW) v Cam & Sons Ltd*,³⁸ *Federal Commissioner of Taxation v French*³⁹ and *Federal Commissioner of Taxation v Efsthakis*⁴⁰). This approach to determining the source of dependent personal service income has traditionally been adopted by the Commonwealth Attorney General,⁴¹ the ATO⁴² and tax commentators.⁴³

However, there are some exceptions. For example, a bonus (made outside the contract of employment) may have a different source to the usual salary paid to a general

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- 37 In *Diamond v Commissioner of Taxes (Qld)* [1941] Qld SR 218, 2 AITR 190, 6 ATD 111 the Supreme Court of Queensland held, implicitly (as the issue involved power to tax in Territorial waters), that part of income derived by a NSW resident ships pilot, who piloted foreign vessels down Australia's east coast, (spending 16.9 percent of the distance within three miles of the Queensland coast) was derived in Queensland as that was where the services were performed.
- 38 (1936) 36 SR (NSW) 544; 4 ATD 32.
- 39 (1957) 98 CLR 398; 11 ATD 288; 7 AITR 76. The taxpayer, who was employed as an engineer by an Australian company in New Zealand, with his salary paid into a Sydney bank, unsuccessfully claimed the income was exempt under former s 23q as it was derived from sources outside Australia.
- 40 (1979) 9 ATR 867, 871; 79 ATC 4256, 4260 (Bowen J) noted "[t]he payment of remuneration depended upon actual performance of the services. That Australia was the place of employment was not merely incidental but central to the earning of the income, to the personal circumstances of the taxpayer and to the nature of the employment."
- 41 In opinion 660 issued by RR Garran Secretary of the Attorney-General's Department on 20 October 1915, Garran stated that source salary income was where the services were performed. Thus, an Australian marine superintendent supervising the construction of a steamship in England on behalf of his Australian company was found to have income source outside Australia, while employee of an English company in Australia has his income source in Australia. Patrick Brazil and Bevan Mitchell (eds), *Opinions of Attorneys-General of the Commonwealth of Australia Volume 2: 1914-23* (1988), 133.
- 42 This view has existed from the time the 1936 Act was introduced (see John Vincent Ratcliffe, John York McGrath and JWR Hughes, *The Law of Income Tax (The Commonwealth)* (1938), 169. They cite the example of *Robertson v Federal Commissioner of Taxation* (1937) 57 CLR 147, 150; 1 AITR 152, 155; 4 ATD 355, 356 (Dixon J) who noted "... It does not appear to me to be altogether clear that the source of his remuneration during his absence was outside Australia, but for some reason it was admitted on behalf of the Commissioner that in respect of the income in question this condition of the Commonwealth exemption was satisfied") and currently (ATO's second Internet Report, above n 7, para 5.3.42, states that "[e]mployment is considered to be exercised in the place where the employee is physically present when performing the activities for which the employment income is paid").
- 43 JP Hannan, *A Treatise on the Principles of Income Taxation* (1946), 272 refers to the judgment of Evatt J in *Hillsdon Watts Ltd v Commissioner of Taxation (NSW)* (1937) 57 CLR 36, 54; 1 AITR 42, 53; 4 ATD 199, 210, who stated obiter "[i]n ascertaining the territorial sources of income derived from personal exertion, it is necessary to ascertain where the material efforts of the taxpayer were in fact exerted." Similarly, Norman Bede Rydge, *Federal Income Tax Law* (1921), 89 cites *In re Gunter* (1895) reported in D'Arcy-Irvine *Land and Income Tax Law of New South Wales* (1905), 429, where the Court of Review held the income was earned where the taxpayer worked, not where he was paid.

manager as it is voluntary in nature.⁴⁴ The place or places where past personal services are rendered can also be a factor in determining the source of a pension⁴⁵ as can the place where it is granted or the place in which the contract was made which gave rise to the pension.⁴⁶ Also, “[i]n the case of an appointment to a sinecure the engagement and the payment may be the only significant factors.”⁴⁷ A “sinecure” is an office of profits or honour without duties, eg an appointment as company director.

On balance, the place where services are performed is a good starting point in determining source, but the place where services are performed is not a rule of law and not always determinative.⁴⁸

(b) *Impact of treaties*

Under Australia’s DTAs there are a number of Articles that modify the approach adopted domestically. There is a principal Article that deals with income from employment and specific articles that allocate taxing rights in respect of specific categories of personal income, such as directors’ fees, entertainers (artistes and

44 In *In re Taxpayer* (1929) 24 Tas LR 14; R & McG (1928-1930) 356 the Supreme Court of Tasmania found that although the salary was derived in Tasmania, the bonus paid had a Victorian source as it was a voluntary payment by a Victorian company and it did not arise or accrue and was not derived or received in Tasmania.

45 In opinion 778 issued by RR Garran Secretary of the Attorney-General’s Department on 23 March 1917, Garran stated that since the pensioner was employed practically for his whole 41 year working life in Australia, the source was Australia. This was despite the fact that taxpayer had his salary paid half yearly from the London Office of his employer bank and that the pension was paid from the guarantee and provident funds of the London employer - Brazil, above n 41, 266.

46 For example, in *Fletcher Dixon v Commissioner of Taxation* (NSW) (1913) R & McG, NSW Court of Review Decisions (1927), 8, the taxpayer purchased two annuities which were signed and issued in New York, but were lodged in the New South Wales office’s of the insurance company. As under the contract the payments were to be made where the annuitant lived, Murray DCJ found that the source was where income was received, New South Wales.

The place in which the assets of the pension fund are located, terms of the deed, residence of trustees or the place of management are other factors that may assist in determining the source of pension income. Similarly, the source of an annuity payment is the place where the contract or will was made or the jurisdiction in which the laws can interpret or determine the validity of the contract or will – see Hamilton, above n 3, para 2.550.

47 *Commissioner of Taxation (NSW) v Cam & Sons Ltd* (Jordon CJ) (1936) 36 SR (NSW) 544, 548; 4 ATD 32, 34. Also in *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, 405; 7 AITR 76, 79; 11 ATD 288, 290 (Dixon CJ)) noted that as the taxpayer did not occupy an office, was not a professional (as in *Watson*), and was not an artisan, the criteria for determining source in those circumstances cannot be used.

48 In *Federal Commissioner of Taxation v Mitchum* (1965) 113 CLR 401, 408; 13 ATD 497, 502; 9 AITR 559, 568 (Taylor J) noted “I do not feel compelled or persuaded by the decision of the Court in French’s case to hold that in every case where work forms the consideration for wages or salary paid the source of the income constituted by the wages or salary is in the place where the work is done.”

sportsmen), pensions, government services, students, diplomats, teachers, alimony and fringe benefits.

(i) *Income from employment Article*

The principal Article under the OECD Model Convention is Article 15, the Income from Employment Article (formerly the Dependent Personal Services Article).⁴⁹ This Employment Article has been adopted in all Australian DTAs, but varies in form depending upon the date at when treaties were negotiated.

Article 15(1) provides that generally salary and wages and similar remuneration⁵⁰ of employees are taxable in the country where the employment is exercised, except where the income is dealt with under Articles (ie, directors' fees, pensions and government service).⁵¹ The categories of income dealt with outside the employment Articles are wider in some Australian DTAs.⁵²

Article 15(2) states that the person's country of residence can only tax employment income derived in the other country if:

- the recipient is present in the other country for a period or periods not exceeding the aggregate 183 days⁵³ in any 12 month period;⁵⁴

49 The name changed with the deletion of the Independent Services Article (Article 14) from the OECD Model Convention on 29 April 2000.

50 Share options are treated as "similar remuneration" - see *2003 United Kingdom Convention Notes*, note 8(a).

51 Generally, the overriding Articles in 2003 OECD Model Tax Convention are arts 16 (directors' fees), 18 (pensions) and 19 (government service).

52 Eg encompassing a Fringe benefits Article and a Teachers Article. Where a Students Article exists in a DTA, Australia does not generally specify it as an override Article.

53 The number of days in the Australian DTAs is not always 183 days. A period of 90 days is used in the DTAs with Papua New Guinea art 15(2)(a), Fiji art 15(2)(a), and Kiribati art 15(2)(a), while a 120 days is used in the DTA with Indonesia art 15(2)(a). The 2003 OECD Commentary on Article 15, paras 5-8 discusses the process for calculating the number of days and other conditions. The Article was altered in light of recommendations contained in OECD, *The 183 Day Rule: Some Problems of Application and Interpretation* (1991).

54 In most Australian DTAs, the "12 month" test is limited to the tax (fiscal) year or year of assessment. The OECD "any 12 month" test period, which effectively measures the 183 days over two tax years, is used in 12 of Australia's DTAs in art 15(2)(a) (unless indicated otherwise), ie, with the United Kingdom art 14(2)(a), Canada, New Zealand, Indonesia, Czech Republic, Taiwan, South Africa, Slovak Republic, Argentina, Romania, Russia and Mexico. The test period is different in the DTAs with Norway art 15(2)(a) and China art 15(2)(a) (which expressly states the

- the remuneration is paid by, or on behalf of, an employer who is not a resident of that other country;⁵⁵ and
- the remuneration is not deductible in determining taxable profits of a permanent establishment or a fixed base which the employer has in that other country.⁵⁶

Remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic or from inland waterway transport may be taxed by the State in which the “place of effective management” of the employing enterprise is situated under Article 15(3). The Australian DTAs do not contain references to inland waterways and in most DTAs the taxing rights in respect of the employment income are allocated to the country where the operator of the ship or airline is “resident”, not the “place of effective management” (as specified in the OECD Model).⁵⁷

(ii) *Director’s fees*

Article 16 of the OECD Model Convention allocates the taxing rights in respect of fees and similar payments, derived by a non-resident director (in the capacity as a member of the board of directors),⁵⁸ to the country in which the paying company is a resident. Although traditionally Australia has adopted this approach, in some DTAs the director’s

measurement period to be two years), and the DTA with Malta art 15(2)(a) (which treats the exemption satisfied if less than 183 days were spent in the country in the preceding 12 months).

55 For the ATO’s view on meaning of the word “employer” see Taxation Ruling TR 2003/11, *Income Tax: The Interpretation of the General Exclusion Provision of the Dependent Services Article, or its Equivalent, of Australia’s Double Tax Agreements*.

56 The DTA with Fiji does not contain the art 15(2)(b) and (c). Also, a fourth requirement (that the income must be subject to tax in country of residence) is contained in the DTAs in art 15(2)(d) (unless indicated otherwise) with New Zealand, Sweden, Malta, Finland, Austria, Papua New Guinea, Fiji, Kiribati, Indonesia, Vietnam, Taiwan, and the Slovak Republic. Similarly, the Norway DTA art 15(2) reserves the right to tax income to the extent it is exempt in country of residence.

57 There are exceptions in art 15(3) (unless indicated otherwise) of the DTAs with: Singapore art 11(3), Netherlands, and Italy (which allocates taxing rights based upon the employee’s residence), Denmark and Romania (which allocates on place of effective management), Denmark and Norway (which override general allocations where person is a SAS employee by allocating rights to Denmark/Norway), Taiwan (which allocates to the territory of operation) and South Africa, Argentina, Russia and Mexico (which allocate to the state in which the enterprise is “resident”).

58 The words “derived in the capacity of as a member of the board of directors” emphasise that this clause only assigns taxing rights to income derived from that office and does not cover remuneration earned by a board member who also has day-to-day management functions – see different wording in DTAs with Singapore art 11(2), Belgium art 16 and Philippines art 16, which stresses this differential treatment. Cf with the Netherlands DTA, which assigns the taxing rights to any income received from the company by a director.

remuneration has been subsumed into the Employment Article, with the remuneration treated in the same way as if it was derived by an employee.⁵⁹

(iii) *Entertainers and sportspeople*

Article 17(1) of the OECD Model Convention overrides the Business Profits (Article 7)⁶⁰ and Employment (Article 14) Articles to allocate the taxing rights in respect of income derived from the personal activities of non-resident entertainers (such as theatrical, motion picture, radio or television artistes and musicians) or sportspersons⁶¹ to the country in which the activities occurred.⁶² Article 17(2) provides that where that income “. . . accrues not to that entertainer but to another person, that income may, notwithstanding the provisions of Articles 7, and 15, be taxed in the” country in which the activities of the entertainer are exercised.⁶³

This article has been incorporated into all Australian DTAs.⁶⁴ However, in some Australian DTAs the Article varies from the OECD Model by allocating residency taxation in respect of state sponsored entertainers⁶⁵ and members of any league teams

59 Eg, DTAs with United Kingdom art 14(4), United States art 15(1), and Japan art 11(4).

60 In DTAs with Independent Service Articles (art 14) is used rather than the Business Profits Article (art 7).

61 In older DTAs the terms “athletes” or “sportsmen” are substituted.

62 “Article 17 is merely a pragmatic recognition that the standard rules applying to personal services income do not adequately cover this type of taxpayer . . . [it] is a ‘tax grab’.” Daniel Sandler, *The Taxation of International Entertainers and Athletes – All the World’s a Stage* (1995) cited in Mark Keating, ‘That’s entertainment – Taxation of entertainers and athletes in New Zealand’ (1998) 4 *New Zealand Journal of Taxation Law and Policy* 3, 8. The justification for the Article has been questioned – see Joel Nitikman, ‘Article 17 of OECD Model Income tax Treaty – An anachronism?’ (2001) 22 *Tax Notes International* 2637.

63 Article 17(2) is aimed at capturing payments under “loan-out” arrangements where the entertainer or sportsperson has an interest in the contracting entity – see Dick Molenaar and Harald Grams, ‘Rent-A-Star – The purpose of Article 17(2) of the OECD Model’ (2002) 56 *Bulletin for International Fiscal Documentation* 500. The approach in the Japan DTA (art 12(2)) is more restrictive with source base taxation (via a deemed permanent establishment) only arising where the entertainer or sports person “controls, directly or indirectly” the enterprise.

64 See generally Thomas Delany, ‘International entertainers: A comparison of the taxing rules’ (1996) 7(6) *The CCH Journal of Australian Taxation*, 52. Also note Australia has introduced specific withholding obligations under the PAYG rules in respect of payments made to performing artists or sportspersons, as well as payments to support staff such as choreographers, coaches, directors of photography, musical directors, and sports psychologists – see Minister for Revenue and Assistant Treasurer, ‘Maintaining the Momentum of Business Tax Reform’ (Press Release C57/02, 14 May 2002), *Taxation Administration Act 1953* (Cth) ss 12-315 and 12-317 and *Taxation Administration Amendment Regulations 2004* (No 1).

65 The DTAs with residency taxation of public sponsored entertainers in art 17 (unless indicated otherwise) are Singapore art 12(3), Philippines, Malaysia art 16, Norway, China (cultural exchanges), Thailand, Sri Lanka, Fiji, Hungarian (includes non-profit organisations), Poland

playing in a trans-Tasman competition,⁶⁶ and providing exceptions to the anti avoidance rule in Article 17(2).⁶⁷

(iv) *Pensions and annuities*

Article 18 of the OECD Model Convention allocates taxing rights in respect of non-government pensions or similar remuneration to the country where the recipient is resident. This sole taxing Article appears in all Australian DTAs.⁶⁸ However, the Australian Article varies from the OECD model in that it encompasses all pensions,⁶⁹ including Government pensions,⁷⁰ and seeks to tax annuities.⁷¹ Despite the existence of

(cultural exchanges), India, Indonesia, Spain, and Argentina Art 17(3). The United States DTA retains residence taxation under art 17(1) for amounts less than US\$10,000.

66 New Zealand art 18. However, the residency test is limited to sporting competitions involving only trans-Tasman teams and does not cover competitions such as Rugby Union's Super 12's, which involves South African teams – see J McCormack and A Archer, 'The New Australia/New Zealand Double Tax Agreement: A Review of the Critical Issues' (Paper presented at the ATAX Second Annual International Tax Weekend Workshop, Sydney, 26-28 May 1995), 24. However, Murray McClennan, 'Tax implications of the growth of professional sport' (1996) 2 *New Zealand Journal of Taxation Law and Policy* 40, 48 mistakenly limits the scope of the clause to the "rugby" league competition.

67 United States art 17(2), Canada art 17(3) and Switzerland art 17(3) allows residence taxation under art 17(2) of third party income if entertainer does not benefit under the arrangement.

68 Despite Australia's position the DTAs contain a number of exceptions where pensions are taxable in the country of payment. These exceptions are

- South Africa art 18(2) - where annuities are purchased by former residents;
- Philippines art 18(1) - payment from unregistered private pension plan;
- Indonesia art 18(2) - country of payment can also levy a 15 per cent tax;
- Canada art 18(2) - country of payment can also levy a 15 per cent tax, and, in respect of income averaging annuities, this limitation does not apply;
- Singapore art 13(3), Japan art 13(3), Netherlands art 19(1), Malaysia art 18(2), and Fiji art 19(1) – where government pensions arise from discharging government functions;
- France art 18(3), Belgium art 19(2), Korea art 19(2), Austria art 19(2), China art 19(2), Thailand art 19(2), Sri Lanka art 19(2), India art 19(2), and Spain art 19(2) – where government pensions arising from discharging government functions/services are rendered provided the retiree is not a citizen and is not a resident of Australia;
- Russia art 19(2) and South Africa art 19(2) – where government pensions arising from services rendered to government are provided retiree who is not a citizen and is not a resident of Australia and the pension relates to services in Australia;
- United States art 18 - government pensions and social security pensions; and
- Sweden art 18(3), Denmark art 18(3), and Finland art 18(3) – where government pensions arising from discharging government functions and social security payments to citizens.

69 Australia reserves the right to depart from Article 18 and solely tax all pensions in country of residence of recipient – see 2003 OECD Commentary on Article 18, para 39. As a result exempt Government pensions in one country can be taxable in the country of receipt - see *Enoch v Federal Commissioner of Taxation* (2002) 51 ATR 1014; 2002 ATC 2201.

70 An illustration of Australia's approach is the ATO's Practice Statement PS 2002/1, *Pensions Paid to Australian Residents by the Netherlands Government for Government Services in the Former Netherlands East Indies*.

71 Other minor variations in wording also exist. For example, the absence of the word "only" in art 18(2) of the Malaysian DTA has meant that both countries had the right to tax - see *AAT Case 12772: Re Chong and Federal Commissioner of Taxation* (1998) 38 ATR 1109; 98 ATC 2069.

such clauses some countries have sought to also tax such pensions in contravention of the DTA.⁷²

(v) *Government services*

Article 19(1) of the OECD Model Convention allocates the taxing rights, in respect of government (federal, state and local) service payments made to individuals, to the country making the payments (provided the employee is a national of the country and did not become a resident of that country solely for the purposes of rendering services).⁷³ This Article, which is used in all Australia's DTAs, varies from the OECD Model in terminology⁷⁴ and does not generally deal with government pensions (as they are normally dealt with under the Pension Article).⁷⁵

Under 19(3) of the OECD Model, payments that relate to services in connection with trade or business carried on by Governments are allocated in accordance with the Articles (where existing) that expressly deal with employment income, entertainers, pensions and directors' fees. Some Australian DTAs also vary from the OECD Model in respect of non-cash benefits, which are dealt with under a Fringe Benefits Article.⁷⁶

The taxpayer was an Australian resident in receipt of a Malaysian civil service pension in respect of his employment with the Malaysian Inland Revenue Department.

72 For example, in response Italy's insistence on taxing these pensions the Commissioner issued Taxation Ruling IT 2554, *Income Tax: Australia/Italy Double Taxation Agreement: Italian Pensions Derived by Australian Residents*, which set out the means by which Australian resident may be entitled to a refund from the Italian revenue authorities of any Italian tax that has been deducted from an Italian pension (derived on or after 1 July 1987) contrary to the provisions of Art 18 of the Convention (para 27). In the event that a refund of tax is not obtained, the Commissioner will grant a credit in respect of the tax paid would not be available in Australia under the foreign tax credit system, as the Italian tax would have been imposed in contravention of the Convention. (para 28).

73 The proviso was inserted to prevent a state taxing remuneration of locally engaged embassy staff - Jevana O'Brien, 'Double tax agreements' in KDCM Wilde and W Rafiqul Islam (eds), *International Transactions: Trade and Investment, Law and Finance* (1993) 298, 306.

74 It uses the words "services rendered in discharges governmental functions" rather than "services rendered to that state."

75 As a result, Australian DTAs do not include Article 19(2) of the OECD Model Convention. A list of the DTAs in which Australia has departed from its taxation of all pensions on a residence basis by agreeing that country of source can tax government pension are listed above, n 68.

76 For example the United States consists of Art 19(1)(a) only.

(vi) *Students*

Article 20 of the OECD Model Agreement provides that payments received by the student or business apprentices from sources outside the country, where made for the purpose of the student's maintenance or education, are exempt in the country where the student is temporarily present.⁷⁷ This Article, which is adopted in all of Australia's DTAs, modifies Australia's domestic law. Without this Article the students, as residents, would be taxable in Australia on income from all sources.⁷⁸ As with other OECD Articles, Australian DTAs use slightly different terminology⁷⁹ and in some DTAs the scope of the article has been varied.⁸⁰

(vii) *Diplomats*

Article 28 of the OECD Model Convention provides that "nothing in the Convention shall affect the fiscal privileges of members of diplomatic missions and consular posts under the general rules of international law or under the provisions of special international agreements."⁸¹ Although this exemption also appears in most of Australian DTAs,⁸² the phrasing of the Article in some earlier Australian DTAs departs from the language of the OECD Model.⁸³

77 Australia reserves the right to depart from Article 20 and restrict its operation to students – see 2003 OECD Commentary on Article 20, para 3.

78 Taxation Ruling IT 2268, *Residency Status of Overseas Students Studying in Australia* concessionally deems overseas students to be residents if their course of study extends beyond six months.

79 The term "business apprentices" is not used in Australian DTAs, but the term "trainee" is included in the following 11 Australian DTAs: Singapore art 15, Malaysia art 20, Korea art 21, China art 21, Thailand art 21, Fiji art 22, Hungary art 21, Kiribati art 20, Indian art 21, Czech Republic art 20 and Slovak Republic art 20.

80 In some DTAs the presence is more than "temporary" being unlimited in some DTAs (Singapore art 15, Japan art 16, South Africa art 20 and Mexico art 20) and limited to seven years under the Romania DTA (art 20). The China DTA extends the art 21(1) exemption to all grants, scholarships and remuneration for a students maintenance, education or training (art 21(2)), while the Malta DTA limits to eligible education to studies at a college, university or school or like (art 20).

81 Diplomatic and consular representatives in Australia are exempt from all income tax under s 23(a)(ii) of the 1936 Act, except on their private income having its source in Australia and capital taxes on investments made in commercial undertakings in Australia. This exemption is done by reference to exemptions in s 7(4) of the *Diplomatic Privileges and Immunities Act 1967* (Cth) and s 5(4) of the *Consular Privileges and Immunities Act 1972* (Cth).

82 The Diplomatic and Consular Article does not appear in the Singapore, Japan and Taiwan DTAs.

83 The DTA which varies the scope of the Article is the DTAs with Canada art 26(2), French art 26(2), Swiss art 26(2) and (3), and Malta art 26(2) and (3) expressly excluding international

The OECD Model Convention generally makes no special provision for teachers and professors, treating them under the Employment Article.⁸⁴ However, 19 of Australia's DTAs contain a Teacher Article,⁸⁵ which allocates the taxing right to the country of residence in respect of any income received by a professor or teacher visiting the other country for a period not exceeding two years for the purpose of teaching or carrying out advanced study or research at a university, college, school or other educational institution.⁸⁶

A number of the Articles expressly exclude remuneration which a professor or teacher receives for conducting research if the research is undertaken primarily for the private benefit of a specific person or specific persons.⁸⁷ Due to the combination of an exemption under the Teacher Articles and an exemption arising from the operation of domestic law of the country of residence, teachers can be tax free in both countries. To avoid this risk, Teacher Articles are not generally adopted in Australian DTAs.

organisations and their staff and reserves the right, as sending country, to tax diplomatic staff of a third State.

84 For example under the United States DTA, exchange teachers paid by the country of residence do not discharge Government functions – Taxation Ruling IT 2574, *Income Tax: Australia/United States Double Taxation Convention: Exchange Teachers*.

85 The Teacher Article appears in art 20(1) (unless otherwise indicated) in the following 19 Australian DTAs: Japan art 15, German art 19(1), Netherlands, France art 19(1), Belgium art 20(2), Philippines, Malaysia art 19(1), Sweden art 20, Ireland art 21(1), Italy art 20, Korea art 20, China, Thailand, Fiji, Hungary, India, Poland, Indonesia, and Argentina.

86 The requirements are that the person must have been:

- a teacher in their home country;
- a resident of that country; and
- visiting Australia for a period less than two years;

the purpose of the visit is to teach in the university, school, etc; and the remuneration is received for those teaching activities. See Taxation Determination TD 2001/21, *Income Tax: Is Salary Paid to a French Resident Employed as an Assistant Teacher in an Australian School Exempt Income?*, Taxation Determination TD 2001/22, *Income Tax: Is Salary Paid to a German Resident Employed as an Assistant Teacher in an Australian School Exempt Income?*, Taxation Determination TD 2001/23, *Income Tax: Is Salary Paid to an Italian Resident Employed as an Assistant Teacher in an Australian School Exempt Income?*, and Taxation Determination TD 2001/24, *Income Tax: Is Salary Paid to a Japanese Resident Employed as an Assistant Teacher in an Australian School Exempt Income?*.

87 The 14 DTAs, which include in art 20(2) (unless otherwise indicated) this express restriction, are the: Netherlands, France art 19(2), Belgium, Philippines, Malaysia art 19(2), Ireland art 21(2), China, Thailand, Fiji, Hungary, India, Poland, Indonesia, and Argentina. A further restriction (that the remuneration must be subject to tax in state of residence) is found in art 20(1) (unless indicated otherwise) of the nine DTAs with: Malaysia art 19(1), Sweden art 20, Italy art 20, China, Hungary, India, Poland, Indonesia, and Argentina.

(ix) *Alimony*

Although the OECD Model Convention does not address alimony or maintenance payments, some of Australia's more recent tax agreements allocate taxing rights under the Pensions and Annuities Article.⁸⁸ However, unlike pensions, the taxing rights in respect of alimony and other maintenance payments are allocated to the country of payment.⁸⁹

(x) *Fringe benefits*

Two Australian DTAs adopt an Article, not in the OECD Model Convention, that allocates taxing rights in respect of fringe benefits.⁹⁰ The Article allocates the right to tax fringe benefits (where a fringe benefit is taxable in both countries) to the country with the sole or primary right to tax the remuneration from employment, to which the benefit relates. The "primary taxing right" is defined to lie with the country that has the right to tax employment income under this agreement. The other country is required to provide relief for tax paid on the employee's remuneration.⁹¹

(c) *In summary*

In summary, at common law, personal service income is generally sourced where the services are performed,⁹² while DTAs allocate taxing rights to either the country where the income was received or generated or to the country of residence or payment. Taxing rights will be allocated to the country of payment where the income arises from that

88 The Alimony Article is art 18(3) (unless indicated otherwise) in 21 Australian DTAs: United States art 18(6), Canada, New Zealand art 19(3), Malaysia art 17(3), Sweden art 18(4), Ireland art 19(3), Italy, Norway, Finland art 18(4), Papua New Guinea, Sri Lanka, Fiji, Kiribati, Indonesia art 18(4), Spain, Vietnam, Czech Republic, Slovak Republic, Argentina, Romania and Mexico.

89 Alimony or maintenance payments are not assessable in Australia – see 1997 Act s 53-30.

90 The fringe benefit Article appears in the United Kingdom art 15 and the New Zealand art 16.

91 The fringe benefit article was introduced in the 1995 New Zealand DTA, principally due to the high degree of similarity in the systems for taxing fringe benefits (both the Australian and New Zealand tax employers on the value of certain fringe benefits provided to employees) and in recognition of developments in trans-Tasman labour markets – see Treasurer, 'Double Taxation Agreement with New Zealand' (Press Release No 6, 27 January 1995), 2.

92 ATO's second Internet Report, above n 7, 105 notes that "[e]mployment is considered to be exercised in the place where the employee is physically present when performing the activities for which the employment income is paid. It follows that an individual who performs those activities outside Australia will not be regarded as exercising their employment in Australia, even where the

country's government⁹³ or where a resident company makes payments to office holders resident in the other country,⁹⁴ and to the country of residence where residents visit the other jurisdiction for short periods.⁹⁵

3 Independent Personal Service

As mentioned above, the next step is to explore the process for determining the source of independent personal service income by first looking at common law before looking at the impact of DTAs.

(a) *The common law factors which determine source*

In respect of income from a personal service business or profession (independent personal services), where payment is based on a result, the common law weightings appear to focus less on the place of work.⁹⁶ As trades and professions are based upon activities, not attached to any specific contract, a doctor or trader is carrying on one business, regardless of where performed.⁹⁷ It is said "an ordinary artisan does not earn his pay where he does his work".⁹⁸ Thus, where services are provided through a contract, then the place of contracting rather than where the services were performed

results of those employment activities are provided directly to an Australian employer via the Internet and are utilised solely in Australia."

93 Eg, income earned by diplomats, persons engaged in Government service, some pension (usually governmental service or social security pensions), and students.

94 Eg, company directors.

95 Eg, persons working in the second country for less than 183 days and teachers.

96 *Watson v Commission of Taxation (WA)* (1930) 44 CLR 94; 1 ATD 61. The Board of Review in *Case M49* (1961) 12 TBRD 260, 265-6; *Case 38* (1961) 10 CTBR (NS) 248, 253-4 (JL Burke, RC Smith QC and RE O'Neill) (*Mitchum's* case at first instance) found (similar to *Watson's* case) that the place of shooting was an element of little importance as Mitchum, a film actor resident in California, was available for creative consultation and rehearsal before shooting and for a period after shooting. Further, the contract for his services with a Swiss company also allowed for exploitation of his name. Therefore, "... the circumstances of this case invest the locus of the contract for his services and the place where payment was to be made thereunder with such added weight as to transform them into deciding factors; as both there factors were outside Australia we conclude that the taxpayer did not ... derive income from sources in Australia."

97 *Bennett v Marshall* (1938) 1 KB 591 and *Watson v Commission of Taxation (WA)* (1930) 44 CLR 94; 1 ATD 61. *Watson*, a public accountant ceased business in Western Australia for 13 months to pursue a single client's matter. The full High Court agreed with the earlier findings of fact that he carrying on business as an accountant in Perth. "Because he journeyed into another jurisdiction in the course of his exertions to do so it did not follow that any part of the source of the remuneration was there located."

98 *Federal Commissioner of Taxation v French* (1957) 98 CLR 398, 405-6; 7 AITR 76, 79; 11 ATD 288, 290-1 (Dixon CJ).

may determine the source of personal exertion income.⁹⁹ If an activity is to be carried out in a particular place, then location may be determinative.¹⁰⁰

Thus, in respect of independent personal services, the place of business or the place of contract may be weighted more heavily in determining source than the place where the work is carried out.

(b) *Impact of treaties*

The Independent Personal Service Article was deleted from the OECD Model Convention on 29 April 2000, with the income being dealt with under the Business Profits Article (Article 7).¹⁰¹ However, as the Independent Personal Services Article still exists in a number of Australian DTAs and has been included in post April 2000 Australian DTAs, its scope needs to be briefly examined.¹⁰²

99 In *Federal Commissioner of Taxation v Mitchum* (1965) 113 CLR 401; 13 ATD 497; 9 AITR 559, the High Court did not determine the source of the income, merely finding that there had been no error of law by the Board of Review. Taylor J concluded [408, 502, 568] “. . . a real question arises as to whether this is a case, as French’s Case was treated, of wages and salary for work. I have called to attention to the terms of the agreement between the Swiss company and the respondent under which he received the sum of \$50,000.”

100 Richard Dukes, ‘Taxation of non-resident entertainers, artistes, performers, sportsmen and athletes in Australia’ (Paper presented in Sydney, 1 September 1995), 10.

101 The deletion was based on a report (OECD, *Issues Related to Article 14 of the OECD Model Tax Convention* (27 January 2000)) which noted that as there was no intended difference between the concept of “permanent establishment” in art 7 and “fixed base” in art 14, the continued use of Article 14 could not be justified. Prior to this decision the usefulness of the fixed based concept was widely questioned, eg, see John Huston, ‘The case against ‘fixed base’’ (1988) 10 *Intertax* 282.

102 The only DTA without an Independent Personal Services Article is the 2003 DTA with the United Kingdom. An example of a recent Australian DTAs with a Independent Personal Services Article is the following Article 14 of the Mexican DTA (which was concluded on 9 September 2002):

1 Income derived by an individual who is a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State. However, if that individual:

- (a) has a fixed base regularly available in the other Contracting State for the purpose of performing the individual's activities; or
- (b) is present in the other State for a period or periods exceeding in the aggregate 183 days in any 12 month period commencing or ending in the fiscal period or year of income concerned, as the case may be of that other State,

the income may also be taxed in that other State, but only so much of the income as is attributable to services performed from that fixed base or in the other State during such period or periods.

2 The term "professional services" includes services performed in the exercise of independent scientific, literary, artistic, educational or teaching activities as well as in the exercise of the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Under the former Article 14 of the 1997 OECD Model Convention, income derived by a resident from independent professional services will generally be taxed only in the country of residence, unless there is a “fixed base” in the other state.¹⁰³ Although the “fixed base” has been adopted as a sole test in 22 of Australia’s DTAs,¹⁰⁴ other DTAs use a 183 day presence test, adopted from the United Nations Model.¹⁰⁵ The 183 day presence test is generally used as an alternative to the “fixed base” attachment requirement.¹⁰⁶ There are also a number of other minor variations from the OECD Model.¹⁰⁷

Thus, the Independent Personal Services Article generally provides sole taxing rights to the country of residence of the service provider. However, the country of source will have taxing rights if the individual derives income from activities exercised in a fixed base in the source country or, in some cases, the individual spends more than a specified number of days in that source country.¹⁰⁸

103 It is argued that in order to have a fixed base the non-resident needs to do more than attend to the requirements of a client and the use of the client’s premise will not be a fixed base regardless of time – see Nathan Boidman, ‘Does time alone create a permanent establishment? The courts and Revenue Canada go their separate ways’ (2000) 54 *Bulletin for International Fiscal Documentation* 339, 342.

104 The fixed base is the sole test in 22 Australian DTAs. It is Article 14 (unless indicated) of the DTAs with Canada, Japan art 10, German art 13, Netherlands, France art 13, Belgium, Switzerland, Sweden, Denmark, Ireland art 15, Italy, Korea, Finland, Austria, Hungary, Poland, Vietnam, Spain, Taiwan, Slovak Republic, Romania, and Russia.

105 A number of developing countries use a 183 day test to widen the right to tax such income (as a fixed base need not be established to tax independent service income). The use of the alternative tests in some Australian DTAs increases the source countries taxing rights. Thus, a source country has the right to tax income from independent personal services that arise from a fixed base where the stay is less than 183 days.

106 In 12 of Australia’s DTAs the two tests are used as alternatives in art 14. These DTAs are those with the United States, New Zealand, Norway (183 days in 2 years and must be taxed in other state), China, Thailand (tests are expressed in the negative), Sri Lanka, Indonesia (time period is 120 days in any 12 months), India, Czech Republic, South Africa, Argentina and Mexico. The 183 days is measured (unless specified) for a period or an aggregate of periods exceeding 183 in any 12 month. This is wider than the fiscal year limitation.

An additional monetary limit test is used in conjunction with the two alternate tests in further 5 DTAs. These DTAs are those with Philippines (fiscal year and \$A10,000 as varied), Malta (183 days but time period is measured by preceding 12 months, and income must exceed \$A12,500 as varied), Papua New Guinea (time period is 90 days in any 12 months, and income must exceed \$A8,000), Fiji (year of income and gross remuneration must exceed \$A8,000 (or as varied) and Kiribati (but time period is 90 days in any 12 months, and income must exceed \$A8,000 or as varied).

107 The term “individual” is used in the Australian DTAs rather than the term “resident” and Singapore DTA (art 11(1)) allocates taxing rights based on the country of activity, while the Malaysia DTA (art 14) combines its dependent and independent service Articles, resulting in the test for independent services being the OECD art 15(2) 183 day test.

108 ATO’s second Internet Report, above n 7, 104.

(c) *In summary*

In summary, at common law, independent personal service income is generally sourced where the business is conducted as illustrated by the contracts or payments. Similarly under DTAs the taxing right is always the country of residence unless the independent contractor has established a fixed base in the other country.

4 *Observations*

Under the common law the weighting in determining the source of employment income is different in determining the source of income from independent personal service. The place of service often gives weight to the determination of the source of employment income, while the place of business often gives weight to the determination of the source of income from personal services.

Although DTAs seem to mirror the broad weightings in respect of independent service income (taxing where a fixed base exists), the taxing rights in respect of employment income are not always allocated to where services are performed. The DTAs allocate taxing rights to the country of residence or payment where:

- the income arises from that country's government;¹⁰⁹
- that country's residents visit the other jurisdiction for short periods;¹¹⁰ and
- the payments are made by a resident company to office holders resident in the other country.¹¹¹

D. *Income from business*

Having outlined the scope of the statutory source and origin rules and the principles at common law in relation to income from personal exertion, the next step is to explore the statutory source rules and the principles at common law in relation to income from business.

109 Eg, income earned by diplomats, persons engaged in Government service, some pension (usually governmental service or social security pensions), and students.

110 Eg, persons working in the second country for less than 183 days and teachers.

Income from business from all sources is assessed under s 6-5(2) of the 1997 Act for residents, while under s 6-5(3) of the 1997 Act non-residents are only assessable where it arises from Australian sources. Included in income from business is the gain on the disposal of an asset disposed of in the ordinary course of carrying on a business¹¹² or as part of an isolated profit making scheme.¹¹³ A gain from the mere realisation of an asset is not “ordinary” income.

However, under the comprehensive capital gains regime (CGT),¹¹⁴ that has had operation since September 1985, the gains arising from a CGT Event¹¹⁵ (eg the disposal of a CGT asset)¹¹⁶ are included in assessable income.¹¹⁷ The CGT provisions will not apply to assess a gain if the amount is assessable or is exempt income under another taxing provision.¹¹⁸ Although the CGT provisions have a wide operation outside the business context, it is appropriate to examine them in this context as the operation of the source rules in respect of disposal of assets are impacted.

Therefore, the structure of Part II D is to first explore the statutory source rules in relation to business income before examining the process for determining the source of income at common law. Next, the impact of DTAs on these statutory rules and common law processes is explored. Finally, the impact of the CGT rules and DTAs is examined.

1 *Statutory source rules*

There are two specific statutory source rules relating to business income (rules related to shipping and insurance income), and two specific income allocation rules (rules where business is carried on partly in and partly out of Australia and specific deeming rules

111 Eg, company directors.

112 *London Australian Investment v Federal Commissioner of Taxation* (1977) 138 CLR 106; 7 ATR 757; 77 ATC 4398.

113 *Fairway Estates v Federal Commissioner of Taxation* (1970) 123 CLR 153; 1 ATR 72; 70 ATC 4061, *Federal Commissioner of Taxation v Whitfords Beach* (1980) 150 CLR 355; 12 ATR 692; 82 ATC 4031 and *Federal Commissioner of Taxation v Myer Emporium* (1987) 18 ATR 693; 87 ATC 4363.

114 1997 Act Parts 3-1 to 3-3.

115 1997 Act s 104 -5 lists the CGT Events. An example of an Event is CGT Event 1, which requires calculation of a gain or loss upon the disposal of a CGT asset.

116 1997 Act ss 108-5.

117 1997 Act ss 102-5 and 6-10.

118 1997 Act s 118-20. It overrides the presumption in s 6-25(2) of the 1997 Act that specific provisions prevail over the general.

where a business is controlled off shore).¹¹⁹ The scope of these rules will be explored by first looking at the specific rules before exploring the income allocation rules.¹²⁰

(a) *Shipping*

Division 12 of the 1936 Act deals with source rules relating to shipping income derived by a ship owner or charterer whose principal place of business is out of Australia.¹²¹ Where a ship belonging to or chartered by such a person is used to carry passengers, livestock, mails or goods shipped in Australia, five percent of the amount paid or payable for that carriage is deemed to have an Australian source, regardless of whether that amount is payable in or out of Australia.¹²² Thus, the shipping rules have the flavour of an “origin” (withholding) rule rather than a “source” rule.

(b) *Insurance with Non-Residents*

Division 15 of the 1936 Act sets out the statutory source rules for insurance with non-residents, where the contract is not made with a principal office or branch established by the insurer in Australia.¹²³ Where a person enters into an insurance contract to insure

119 The exempt income rules relating to business income sourced in a specified Norfolk Island (1936 Act ss 24F and 24g) will not be examined.

120 This examination will not include a review of the former “businesses controlled abroad” source rules contained in the former Division 13 of the 1936 Act. The former s 136 was adapted from the 1922 Act s 28, which in turn was based on 1915 United Kingdom legislation. However, the former s 136 was ineffective as it was easy to avoid. Despite recommendations for reform in 1975 (contained in the Asprey Report, above n 10, 267-9) it took the loss in *Federal Commissioner of Taxation v Commonwealth Aluminium Corporation Ltd* (1980) 143 CLR 646; 11 ATR 42; 80 ATC 4371 before the Government responded, by repealing it in 1982.

It was replaced by the current Division 13 of Part III of the 1936 Act, which, since 27 May 1981, has dealt with the shifting of profits from Australia to other jurisdictions via transfer pricing arrangements. Under ss 136AE(1) to (3) the Commissioner can determine the source of a payment and, where there is an “international arrangement” (eg a branch operating through a permanent establishment) ss 136AE(4) to (6) allow the Commission to allocate income and interests between the countries. It is not intended to further discuss these transfer pricing provisions. See generally Kerrie Chalmers, ‘International transfer pricing: The Australian approach and lessons for Canada’ (1998) 46 *Canadian Tax Journal* 303 and Borkowski, Susan C, ‘Electronic commerce, transnational taxation and transfer pricing: Issues and practices’ (2002) 28(2) *International Tax Journal* 1.

121 1936 Act ss 129 to 135A. As mentioned above n 19, these were originally 1891 New Zealand rules, which were incorporated in the Commonwealth law by 1915 Act s 22 and 1922 Act s 27.

122 1936 Act s 129. The Commissioner believes some charter arrangements, outside these measures, are in a nature of a royalty and should be taxed accordingly – see Draft Tax Ruling TR 2002/D11, *Income Tax: The Royalty Withholding Tax Implications of Chartering and Similar Arrangements*.

123 These source rules can be traced to the insertion of s 17A in the *Income Tax Assessment Act (No 2) 1915* (Cth), which assessed non-resident fire insurance premiums. This rule was extended in 1916 to include marine insurance (*Income Tax Assessment Act (No 2) 1916* (Cth)), before being repealed

property situated in Australia against an event occurring only in Australia with a non-resident insurer, the premium is deemed to be derived by the non-resident insurer from sources in Australia and is assessable in Australia.¹²⁴ Similarly, the premiums will also have an Australian source, regardless of where the property is situated or where the event may happen if an agent or representative in Australia of the insurer was in any way instrumental in inducing the entry into that contract.¹²⁵ In both cases the non-resident insurer is deemed to have a taxable income equal to 10 percent of the total amount of such premiums. However, if the taxpayer can calculate the actual profit or loss, the profit is assessed through the normal operation of the Act.¹²⁶

Where a person, carrying on the business of insurance in Australia, reinsures out of Australia the whole or part of any risk with a non-resident, the transaction is ignored under the Act,¹²⁷ unless the resident insurer elects to be taxed as agent for all non-residents reinsurers.¹²⁸

These origin provisions do have commonality with withholding tax rules, as a fixed percentage is deemed to have an Australian source and the expenses incurred in earning that income are denied.

(c) Income allocation where business is carried on partly in and partly out of Australia

The final statutory source rule applies to income derived where goods are manufactured offshore by a non-resident, or goods are purchased off-shore, imported into Australia and sold. Subdivision C of Division 2 of Part III of the 1936 Act assigns an Australian

by *Income Tax Assessment Act 1918* (Cth). It was reintroduced into the 1922 Act ss 23(1)(a)(ii) and 28B (via *Income Tax Assessment Act 1930* (Cth)) and subsequently incorporated into the 1936 Act ss 141 to 148 (with ss 143(1) and (2) introduced to stop non-residents circumventing the operation of the division by dealing directly with clients through a branch in Australia).

124 1936 Act s 142(1).

125 1936 Act s 142(2).

126 1936 Act s 143.

127 The premiums in respect of the reinsurance shall not be an allowable deduction to the resident insurer or be included in the assessable income of the non-resident, and the income of the resident insurer shall not include sums recovered from that non-resident, in respect of a loss on any risk so reinsured - 1936 Act s 148(1).

128 The amount taxed is an amount equal to 10 percent of the sum of the gross amounts of the premiums in the year of income in respect of all such reinsurances - 1936 Act ss 148(2) and (3).

source to any profit¹²⁹ arising on sale from activities conducted in Australia by the non-resident, agent or representative,¹³⁰ which were instrumental¹³¹ in bringing about the sale.¹³² The goods must be in Australia or brought into Australia for the purpose of such sale. If these conditions are satisfied, the income arising is deemed to have an Australian source.

Thus, a transaction will be taxable even where the contract, payment and the delivery is organised from outside Australia.¹³³ The wide scope of the Division means that profit from a casual sale may be held to have a source in Australia¹³⁴ and that it may be wide enough to encompass sales through websites located on a server in Australia.¹³⁵

Where manufacturing operations are carried on (fully or partially) in Australia by a non-resident using materials or components imported into Australia, or where the purchase of goods is by the making of contracts in one country and their performance in another, the determination of the amount of profit from the sale of the goods having a source in

129 The profit in respect of manufacturer goods imported and sold is ascertained under 1936 Act s 38 by deducting from their sale price: (a) the amount for which, at the date the goods were shipped to Australia, goods of the same nature and quality could be purchased by a wholesale buyer in the country of manufacture or their purchase price (if not a manufacturer); (b) the expenses incurred in transporting them to and selling them in Australia; and (c) if the sale is a taxable supply - an amount equal to the net GST payable on the supply.

Asprey Report, above n 10, 273 notes that although s 38 allows reconstruction of the Australian-source profit where the manufacturer's costs have been inflated by prices he has paid to related persons, the calculation of the selling profit under 1936 Act s 39 (where goods have been bought by the non-resident and then imported into Australia) does not allow of any reconstruction.

Finally, the High Court in *American Thread Co v Federal Commissioner of Taxation* (1946) 73 CLR 643; 3 AITR 484; 8 ATD 228 notes that if there is no profit the subdivision has no operation and the income is subject to the ordinary operation of the 1936 Act.

130 Under 1936 Act s 41.

131 Section 41 was introduced in 1936 Act as a consequence of the 1934 Royal Commission recommendations. It codifies Commonwealth practice, drawn from English Court decisions, during World War One. The practice depended upon two of the three following factors occurring in Australia: place of contract, place of delivery or place of payment. This test was easily avoided see Commonwealth of Australia *Income Tax: Explanatory Handbook Showing the Differences Between the Income Tax Assessment Act 1936 and the Income Tax Assessment Act 1922-1934* (1936), 60-1.

132 Sections 38-40 were introduced in the 1936 Act to ensure consistency with the income tax laws in the States and to codify the common law principles operative under the 1922 Act - Explanatory Handbook, *ibid*, 60.

133 ATO's second Internet Report, above n 7, 88.

134 Asprey Report, above n 10, 273.

135 ATO's second Internet Report, above n 7, 88 and Niv Tadmor, 'Aspects of electronic commerce taxation in Australia' (2003) 57 *Bulletin for International Fiscal Documentation* 422, 425-6. However, the ATO's second Internet Report notes (*ibid*, 89) that digit products may not be "goods" and their transfer may not be "sales". Also see Duncan Bentley, 'The ATO, Tax and the Internet: The Emperor's New Clothes?' (1999) 9 *Revenue Law Journal* 98, 131-2.

Australia will be made either under regulation¹³⁶ or by the Commissioner.¹³⁷ Thus, s 42 of the 1936 Act is a profit allocation rule for a transaction not expressly caught in the preceding sections.¹³⁸

Any profits deemed to be derived in Australia by Division 12 are assessable income.¹³⁹ However, no amount taken into account in ascertaining any such profit, and no expenditure incurred directly or indirectly, or in relation to any such sale, shall be an allowable deduction.¹⁴⁰

2 *The common law factors which determine source*

From the above it is clear that the statutory source rules apply in only limited circumstances (ie in respect shipping, insurance and income derived from activities conducted partially in Australia). In order to determine the source of business income outside these statutory criteria, the common law processes for determining source must be explored.

There are a number of factors that will determine source of business income at common law and which factors determine source in any circumstance will depend on which of the factors are dominant¹⁴¹ (ie determines the location of the “essence” of the business that derives the income).¹⁴² These factors include the:

136 As no regulations have been proclaimed the Commissioner has to allocate income, presumably in accordance with the process set out in the common law - see and Michael Littlewood, ‘The uncertain geographical scope of Hong Kong profits tax and the possibility of reform’ (1999) 19 *Tax Notes International* 1441, 1454.

137 1936 Act s 42. Section 42 was an adoption of the former s 16C in the 1922 Act. Asprey Report, above n 10, 274 notes that under s 42 the Commissioner must accept the profit: his function is only to determine how much of the profit has an Australian source.

138 Section 42 was an adoption of the former s 16C in the 1922 Act. Magney, Tom, ‘Source of Income’ (Paper presented at the 10th *Taxation Institute of Australia’s New South Wales State Convention*, Sydney, 26-28 May 1978) 1, 15 notes that s 42 gives statutory effect the apportionment and dissention processed used by the courts in *Commissioner of Taxation (NSW) v Kirk* [1900] AC 588; R & MG 139, *Commissioner of Taxation (NSW) v Meeks* (1915) 19 CLR 568; R & MG 159, *Mount Morgan Gold Mining Company Limited v Commissioner of Income Taxation (Qld)* (1923) 33 CLR 76; R & MG 288, *Federal Commissioner of Taxation v W. Angliss & Co Pty Ltd* (1932) 46 CLR 417; 1 ATD 542 and *Commissioner of Taxation (NSW) v Hillsdon Watts Limited* (1937) 57 CLR 36; 1 AITR 42; 4 ATD 199. Also see *WP Martin and Co Ltd v Commissioner of Taxation (NSW)* (1917) R & MG 160 and *Commissioner of Taxation (NZ) v The Kauri Timber Company* (1904) NZIR 18; R & MG 365.

139 1936 Act s 43(1). Section 43 was inserted as a drafting provision to bring profits within the term “assessable income” - Explanatory Handbook, above n 131, 62.

140 1936 Act s 43(2).

141 *Spotless Services Ltd v FCT* (1993) 25 ATR 344, 359; 93 ATC 4397, 4409-4410 (Lockhart J) relying on *Federal Commissioner of Taxation v Efstathakis* (1979) 9 ATR 867, 870; 79 ATC 4256,

- location of economic activity;
- importance of contracts; and
- location of real property.

The following examination of the process for determining the source of business income will be conducted in the context of the three criteria (above).

(a) *Location of economic activity*

Where there are a series of operations leading to sale and income arises from each stage, then the essence of the business is not the final sale contract.¹⁴³ The place at where that business is conducted can be the source of all or some of the income.¹⁴⁴ This applies equally to sale of goods,¹⁴⁵ provision of services,¹⁴⁶ or where an operation consists of manufacturing or mining.¹⁴⁷

However, the income can only have a source at a particular stage of an operation if there is value added at that stage.¹⁴⁸ If there is no value added at earlier stages then the place of sale may be the determinative factor.¹⁴⁹ The following factors have been seen as important in determining the place where business activities are conducted:

4259 (Bowen CJ), who noted that “. . . the answer is not to be found in the cases, but in the weighing of the relative importance of the various factors which the cases have shown to be relevant.”

142 *Commissioner of Taxation v Meeks* (1915) 19 CLR 568, 587 R & McG 158, 159 (Isaacs J); also *Lovell & Christmas Limited v Commissioner of Taxes* [1908] AC 46, and *Federal Commissioner of Taxation v W Angliss & Co Pty Ltd* (1931) 46 CLR 417; 1 ATD 542 and ATO's second Internet Report, above n 7, 79.

143 *Commissioner of Taxation (NSW) v Kirk* [1900] AC 588; R & McG 139.

144 *Commissioner of Taxation v Meeks* (1915) 19 CLR 568, 586; R & McG 158, 159 (Isaacs J). Rydge, above n 43, 84 notes that “. . . ‘sources’ must be interpreted to mean the business, capital or service from which the income arises.”

145 Eg, wool and skins purchased in Australia sold overseas (*Michell v Commissioner of Taxation* (1927) 46 CLR 413; R & McG 128) and goods manufactured in Australia and sold in New Zealand (*Federal Commissioner of Taxation v Lewis Berger and Sons (Australia) Limited* (1927) 39 CLR 468; R & McG 96).

146 Eg, where salvage was essence of business - *Commissioner of Inland Revenue v The Hong Kong & Whampoa Dock Co Ltd* HKTC 85.

147 Eg, *Morgan Dickson v Commissioner of Taxation (NSW)* (1925) 36 CLR 489.

148 Eg, *Commissioner of Taxation (WA) v D & W Murray Ltd* (1929) 42 CLR 332; R & McG 479. The source of income for a United Kingdom company, which purchased goods for sale in Australia, was the place of sale (Australia) as no value was added in place of purchase.

149 Eg, *Commissioner of Taxation (WA) v D & W Murray Ltd* (1929) 42 CLR 332; R & McG 479 and *Commissioner of Inland Revenue (HK) v HK-TVB International Ltd* [1992] STC 723; BTC 524. Also in *Australian Machinery and Investment Co v Deputy Federal Commissioner of Taxation* (1946) 180 CLR 9; 8 ATD 81; 3 AITR 359 the High Court found that a large profit on shares and

- who controls the entity;
- the location of sales staff;
- the place of negotiation of sales;¹⁵⁰
- the location of technical information/ research and development; and
- the nature of the negotiation process.¹⁵¹

The place where the income is received has also been held to be of considerable significance.¹⁵²

(b) *Place of contract*

Where the whole of the operation is not the essence of the business, the place of contract¹⁵³ may become a significant factor.¹⁵⁴ If the contract forms the “essence of the business” there is no need to look further than the place where the contract is made.¹⁵⁵

options sold for cash in England were found not to have an Australian source as there was no Australian element in the production of this apparent profit. The fact that that a foreign company owns shares in Australian companies is not sufficient to make it proper to declare that any of the profit arose from an Australian source. Similarly, the disposal a Victorian company’s options bought and then sold (in England) were not assessable in Australia as the transaction had an English source.

- 150 Cf *Australian Machinery and Investment Co v Deputy Federal Commissioner of Taxation* (1946) 180 CLR 9; 8 ATD 81; 3 AITR 359 where the High Court took a different approach was taken in respect of shares sold in subsidiary mining companies to seven English companies in exchange for approximately £ 2.8 million paid in cash, shares and options. Although the reason of the various judges is mixed, the majority held that the shares had both an Australian and English source. Latham CJ noted (at 16; 89; 372) that he felt “. . . no doubt that if a person, trading in shares which are locally situated in one country, makes a profit by selling them in another country, the source of his profit is in part the wares and in part the contracts of sale, and the locality of the source is in part the locus of the wares and in part the locus of the contracts: cf. *Maclaine & Co v Eccott* (Inspector of Taxes), [1926] AC 424 at p 431-2; *Commissioner of Taxation (NSW) v Hillsdon Watts Ltd* (1937) 57 CLR 36.”
- 151 *Cliffs International Incorporated v Federal Commissioner of Taxation* (1985) 16 ATR 601, 620; 85 ATC 4374, 4390. Kennedy J concluded that the place of contract was not relevant since “the negotiations were concluded overseas the execution of the contracts in Australia was it seems to me, on the evidence, to have been very much a formality”.
- 152 *Tariff Reinsurances Ltd v Commissioner of Taxation (Vic)* (1938) 59 CLR 194, 217; 1 AITR 280, 292; 4 ATD 498, 510 (Dixon J). Also see generally Magney (1978), above n 138, 17-18 and Littlewood, above n 136, 1447-52.
- 153 This includes where any relevant contracts are negotiated or concluded; where they are performed; the governing law of such contracts; the currency in which the transaction is carried out; and the place where payment is made etc – see ATO’s second Internet Report, above n 7, 79.
- 154 *Federal Commissioner of Taxation v W. Angliss & Co Pty Ltd* (1932) 46 CLR 417; 1 ATD 542. Also see *Premier Automatic Ticket Issuers Ltd v Commissioner of Taxation (NSW)* (1933) 50 CLR 268; 2 ATD 378 and *Tariff Reinsurances Ltd v Commissioner of Taxation (Vic)* (1938) 59 CLR 194; 1 AITR 280; 4 ATD 498 (profits as arose out of where contract accepted). However, in other cases the place where a contract made is of no particular significance (see *Commissioner of Taxation (NSW) v Meeks* (1915) 19 CLR 568 and *Cliffs International Inc v Federal Commissioner of Taxation* (1985) 16 ATR 601; 85 ATC 4374).

Where a contract (formed by a separate offer and a separate acceptance) is concluded is determined by the common law. Generally, the contract is formed at the place where the acceptance is communicated directly to the offeror.¹⁵⁶ For items posted, the courts have held that the acceptance is on postage,¹⁵⁷ provided it can be “inferred that the offeror contemplated and intended that his offer might be accepted by the doing of that Act” (ie posting).¹⁵⁸ To assist in determining where a simple offer and acceptance is communicated via electronic media the Commonwealth and each state have enacted legislation.¹⁵⁹

(c) *Location of real property*

Finally, the location of real property can be a factor in determining the source of income.¹⁶⁰ The location of real property subject to an option, may determine the source of income arising from the disposal of the option.¹⁶¹

155 *Lovell & Christmas Limited v the Commissioner of Taxes* [1908] AC 46. Cf, *Spotless Services v Federal Commissioner of Taxation* (1993) 25 ATR 344, 359-60; 93 ATC 4397, 4410. Lockhart J noted that “[i]n my opinion where the source of interest payable under a contract of loan lies at the heart of the judicial inquiry the place or places where the contract was made and the money lent are of considerable importance; but it goes too far to say that the source of the interest in the present case is necessarily determined solely by reference to the place where the contract of loan was made and the money in fact lent.” See generally Magney (1978), above n 138, 2-9 and Wallace Cameron, ‘Hong Kong corporation profits tax and source of income’ (1976) 5 *Australian Tax Review* 113.

156 *Entores Limited v Miles Far East Corporation* [1955] 2 QB 327 and *Hampstead Meats Pty Ltd v Emerson & Yates Pty Ltd* [1967] SASR 109. This is seen as artificial in a modern world - see NC Seddon and MP Ellinghaus *Cheshire & Fifoot’s Law of Contract* (7th Australian ed, 1997), 80.

157 *Adams v Lindsell* (1818) 106 ER 250.

158 *Tallerman & Co Pty Ltd v Nathan’s Merchandise (Victoria) Pty Ltd* (1956) 98 CLR 93, 111 (Dixon CJ and Fullagar J).

159 *Eg Electronic Transactions Act 1999* (Cth) s 14(5). The legislation confirms that contracts formed electronically are valid and in absence to agreement between the parties, deems the time and the place where an electronic offer and acceptance are made – see Bill Cannon, ‘A practical look at e-commerce and source rules’ (Paper presented at the 4th World Tax Conference, Sydney, 27 February 2004), 10. Also a Convention of Electronic Contracting is being developed by the United Nations Commission on International Trade Law (UNCITRAL) Working Group on Electronic Commerce - see Bjorn Westberg, *Cross-boarder Taxation of E-Commerce* (2002), 206-8.

160 *Eg, Liquidator, Rhodesia Metals Limited (in liquidation) v Commissioner of Taxes* [1940] AC 774 where the profits on the sale of land in Rhodesia were held to be sourced in Rhodesia despite contracts for purchase and sale being completed in London. However, Asprey Report, above n 10, 17.A6 notes there is no definitive decision on the source of a profit from the sale of Australian real property.

161 *In Thorp Nominees v Federal Commissioner of Taxation* (1988) 19 ATR 1834, 1843; 88 ATC 4886, 4894 the profit on the sale of an option to buy land (received at an under valued price) was found to have an Australian source despite the written agreements being signed in Switzerland. Lockhart J in the full Federal Court decision noted: “[v]iewed as a matter of substance rather than form it is plain, in my opinion, that the source of the income in question is Australia not Switzerland. The activities in Switzerland were obviously part of a pre-arranged plan . . . It would give undue weight to matters of form to regard Switzerland as the source of the income in question.”

(d) *Summary*

The source of business income at common law and which factors determine source in any circumstance will depend on which of the factors are dominant (ie those which indicate the true source of the income, be it the location of the business or assets, or the place of contract).

3 *Impact of treaties on business income source*

The OECD Model Convention contains a number of Articles that allocate the taxing rights in respect of business income, including the income from real property, business profits, ships and aircraft, the associated enterprises, alienation of property income, and other income Articles. The impact of the shipping Article will be explored first before exploring the scope of the Business Profits Article (Article 7) under both the OECD Model Convention and under Australia's DTAs.

(a) *Impact of treaties on shipping rules*

The rules governing shipping and airline payments are found at Article 8 of the OECD Model Convention. Article 8(1) allocates the taxing rights in respect of profits arising¹⁶² from the operation of ships and aircraft to the state in which the "effective management" of the enterprise is located.¹⁶³ Most Australia's DTAs differ from the OECD Model Convention as Australia reserves the right to tax profits (under Division 12 of 1936 Act) from internal traffic and from coastal and continental shelf activities.¹⁶⁴ There are also,

162 Under art 8(4) profits include profits arising from participation in a pool service or other profit sharing arrangements. Some Australian DTAs (eg Argentina art 8(4)) include in profits "interest earned on funds held in one of the Contracting States by a resident of the other Contracting State in connection with the operation of ships or aircraft . . . and any other income incidental to such operation." Other DTAs (eg United Kingdom and United States) include in profits, bareboat rental and profits from use, maintenance and rental of shipping containers, provided both activities are incidental to shipping or aircraft operation.

163 If effective management is on the vessel, art 8(3) then the place of home harbour has the taxing right, or if no home harbour, the country in which the operator is resident.

164 See Australia's reservation and observation on the OECD Commentary in paras 8(d) and 9 – 2003 OECD Commentary on Article 8, paras 38 and 30.1 respectively. This approach is adopted in art 8 of most of Australia's DTAs (including United States, Canada, New Zealand, Singapore art 7(5), Japan art 6(4), German, Netherlands, Italy, China, Argentina and Mexico). Some DTAs specify a five percent limitation on art 8(5) (including Belgium, German, French and Netherlands). Article 8(5)(b) of the United Kingdom DTA also allocates profits from the use of ship or aircraft for

terminology differences, with Australian DTAs preferring not to use the place of “effective management”¹⁶⁵ to assign taxing rights under Article 8(3), but to use either the country of residence¹⁶⁶ of the operator or the country in which the operator has an “enterprise of a state”.¹⁶⁷

(b) *Business Profits – Article 7 of the OECD Model Convention*

Article 7(1) of the OECD Model Convention allocates the taxing rights to the country of residency unless the non-resident enterprise carries on business in the country of source through a permanent establishment. If the enterprise carries on such a business the country of source can tax the profits to the extent they are attributable to the permanent establishment.¹⁶⁸ Where income is dealt with in a specific Article of the Convention (such as shipping income), it falls outside the scope of Article 7.

In order for Article 7 to apply to tax business profits in the country of source the threshold elements are that there must be a “permanent establishment” and there must be an “enterprise”. The term enterprise is defined in Article 3(1)(c) to be “the carrying on of any business.” The meaning of the words “permanent establishment” is found at Article 5 of the OECD Convention. It encompasses two types of permanent establishments, a fixed place of business permanent establishment and an agency permanent establishment.¹⁶⁹

haulage, survey, dredging or in relation to exploration or extraction of natural resources to the state in which the activities are undertaken.

165 Effective management is used only in a small number of DTAs (including Romania).

166 Includes DTAs with the United States, Canada, German, French Belgium, Italy and China.

167 Includes DTAs with United Kingdom, South Africa, Russia and Mexico.

168 Article 7(1) provides: “The profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of the profit that is attributable to that permanent establishment.”

169 The test, developed in the 1920’s, was meant to impose a high threshold of presence in the source country - Dale Pinto, *E-Commerce and Source-Based Income Taxation* (2003) 79. See generally Klaus Vogel, *Klaus Vogel on Double Taxation Conventions* (3rd ed, 1997), 271-356, Pinto, *ibid*, 69-84 and Frances M Horner and Jeffrey Owens, ‘Tax and the web: New technology, old problems’ (1996) 50 *Bulletin for International Fiscal Documentation* 516, 517-18.

Thus, a permanent establishment is a fixed place of business¹⁷⁰ through which an enterprise is partially or wholly carried on,¹⁷¹ including: a place of management, a branch, an office, a factory, a workshop and a mine, oil or gas well, a quarry or other place of extraction of natural minerals.¹⁷² It includes a construction site being used for more than 12 months.¹⁷³ However it does not include preliminary or auxiliary activities (such as a storage facility, the holding of stock for storage, display, delivery, purchase, or on behalf of another enterprise, or collection of information).¹⁷⁴

A permanent establishment also includes an agent who has the power to conclude contracts on behalf of the enterprise.¹⁷⁵ However, it does not include a broker or general commission agent of an independent nature.¹⁷⁶

The 2003 OECD Model Tax Convention Commentary notes that a web site and the hosting arrangement will not give rise to a permanent establishment and generally the Internet service provider will not create an agency permanent establishment.¹⁷⁷ However, the place a server is located can be a permanent establishment.¹⁷⁸

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- 170 It is seen by some as “an artificial proxy for residency” - Kerrie Sadiq, ‘Jurisdiction to tax and the case for threshold reform’ (Paper presented at the 16th Australasian Tax Teachers Association Conference, Adelaide, 30 January 2004) 6. “Fixed” implies geographical attachment (a spatial location) and temporal duration (ie a degree of permanency) – Pinto, *ibid*, 73. It is argued that a fixed place of business will not be found if the non-resident merely uses a client’s premise – see Boidman, *above* n 103 and Edwin van der Bruggen, ‘PE implications when furnishing consulting services under OECD and UN Model treaties’ (2001) 22 *Tax Notes International* 2623.
- 171 OECD Model Convention art 5(1) – see 2003 OECD Commentary on Article 5(1), paras 2 to 11.
- 172 OECD Model Convention art 5(2) – see 2003 OECD Commentary on Article 5(2), paras 12 to 15.
- 173 OECD Model Convention art 5(3) – see 2003 OECD Commentary on Article 5(3), paras 15 to 20. The 12 month period for construction projects is at odds with the general thrust of Article 5 as express time limits are not used (eg a PE merely must not be temporary) – see Richard Vann, ‘Tax Treaties in the 1990s’ (Paper presented at the Taxation Institute of Australia’s 3rd National Tax Retreat, Coolumb, 24-26 August 1995), 21-22.
- 174 OECD Model Convention art 5(4) – see 2003 OECD Commentary on Article 5(4), paras 21 to 30.
- 175 OECD Model Convention art 5(5) – see 2003 OECD Commentary on Article 5(5), paras 31 to 35. The permanence under agency permanent establishment is established through the authority being habitually exercised – Pinto (2003), *above* n 169, 74.
- 176 OECD Model Convention art 5(6) – see 2003 OECD Commentary on Article 5(6), paras 36 to 39.
- 177 2003 OECD Commentary on Article 5, paras 42.1, 42.2 and 42.10. For background on the e-commerce aspects of the OECD Commentary see Tadmor (2003), *above* n 135 and OECD, *Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?: Public Discussion Draft* (26 November 2003). Also see Wright Schickli, ‘Characterization of e-commerce revenue – The final OECD Report revealed’ (2001) 22 *Tax Notes International* 1671 and Richard A Westin, *International Taxation of Electronic Commerce* (2000), 549-65.
- 178 2003 OECD Commentary on Article 5, paras 42.3-42.9. For case study illustrating the issues see Pinto, *above* n 169, 88-126. Rather than “stretching” the definition by interpretation in the Commentary changes to the actual OECD Model Convention was preferred by some – see, eg, Niv Tadmor, ‘Clicks vs bricks: The Interaction between the OECD PE concept and Websites’ (2001) 22 *Tax Notes International* 1821, 1831 and Bill Cannon, ‘E-commerce and source of income’

Further, mere control of an entity will not deem a permanent establishment.¹⁷⁹ Although each permanent establishment is treated separately, an arms-length standard is applied to the allocation of income to a permanent establishment via the Associated Enterprise Article (Article 9).

Being a key rule of attachment under DTAs there is much written on what constitutes a permanent establishment,¹⁸⁰ and how income under Article 7 should be allocated to a permanent establishment,¹⁸¹ particularly now due to the growth of e-commerce.¹⁸²

(c) *Differences between Australian Article 7 and the OECD Model*

The Business Profits Article 7 in most Australian DTAs, although similar to Article 7 of the OECD Model Convention, varies from the OECD Model in respect of profits from insurance and reinsurance¹⁸³ and contains a special provision that deems non-resident

(Presentation at the Taxation Institute of Australia's 2nd National Tax Symposium, Werribee Park, 22 November 2002).

- 179 OECD Model Convention art 5(7) – see 2003 OECD Commentary on Article 5(7), paras 40 to 42 Jerome B Libin and Timothy H Gillis, 'It's a small world after all: The intersection of the tax jurisdiction at international, national, and subnational levels' (2003) 38 *Georgia Law Review* 197, 224-34.
- 180 Sadiq, above n 170. A focus of OECD work has been whether electronic presence through a server is sufficient to establish a permanent establishment – see eg OECD, 'Application of tax treaty concepts to electronic commerce' in OECD, *Taxation and Electronic Commerce: Implementing the Ottawa Taxation Framework Conditions* (2001), 79.
- 181 The OECD has continued to review the process of income allocation under Article 7. This started in the early 1990's – see OECD, *Attribution of Income to Permanent Establishments* (1993) and IJJ Burgers, 'The OECD report "Attribution of income to permanent establishments": A commentary' (1995) 49 *Bulletin for International Fiscal Documentation* 137. The issue has been revised over the last five years - see OECD, *Attribution of Profits to a Permanent Establishment: Revised Discussion Draft for Public Comment – Part 1 (General Considerations)* (August 2004). Also see Brian J Arnold, 'Threshold requirements for taxing business profits under tax treaties' (2003) 57 *Bulletin for International Fiscal Documentation* 476, Raffaele Russo, 'Tax treatment of "dealings" between different parts of the same enterprise under Article 7 of the OECD Model: Almost a century of uncertainty' (2004) 58 *Bulletin for International Fiscal Documentation* 472, and Gary Sprague and Rachel Hersey, 'Attribution of profits to permanent establishments' (2002) 25 *Tax Notes International* 629.
- 182 Eg, see OECD, *Draft: The Impact of the Communications Revolution on the Application of 'Place of Effective Management' as a Tie Breaker Rule* (30 June 2001), and OECD 26 November 2003 Public discussion draft, above n 177.
- 183 The taxing rights for profits from insurance and reinsurance payments are allocated under the 'business profits' article (Article 7) of the OECD Model Convention. Article 7 allocates taxing rights in respect of profits of an enterprise to the country of residence. Australia reserves the right to apply domestic law to tax profits or gains derived from any form of insurance - 2003 OECD Commentary on Article 7, para 41. This reservation is reflected in all Australian DTAs (eg Argentina art 7(7)) and preserves the application of Division 15 of Part III of the 1936 Act - see

beneficiaries of a trust, which carries on business in Australia through a permanent establishment, to have a permanent establishment in respect of the share of net income.¹⁸⁴ This latter clause was inserted to overcome an argument that under Article 7(1) non-resident beneficiaries of a trust deriving business profits through a trust could escape liability in Australia as the beneficiary did not have a permanent establishment.¹⁸⁵ However, the article does override the statutory “income allocation rules” (where business is carried on partly in and partly out of Australia) for DTA countries.¹⁸⁶

In respect of some developing nations, source taxation under Article 7(1) is extended to related sales and other business activities¹⁸⁷ and there are also terminology differences.¹⁸⁸

Explanatory Memorandum, Income Tax (International Agreements) Amendment Bill 1995 (Cth), 26.

184 Many DTAs give Australia the right to tax certain receipts that are not taxable under the 1997 Act. For example, the 1997 Act does not tax exempt income, although such income could fall within the business profits article. Thus, the existence of a right to tax does not result in the amount being taxed - see *Commissioner of Taxation v Lamesa Holdings BV* (1997) 36 ATR 589, 592; 97 ATC 4752, 4755.

185 *International Tax Agreements Act 1953* (Cth) s 3(11) was inserted in 1984 to deem the beneficiaries to have a permanent establishment and all post 1994 DTAs included a specific subarticle to serve a similar purpose – see Chapter 4, n 359. The deeming provision appears in arts 5(7) (Singapore), 7(7) (New Zealand), 7(8) (Malaysia, Papua New Guinea, Thailand, Sri Lanka, Fiji, Kiribati, Poland, Indonesia, Vietnam, Spain, Czech, Taipei, South Africa, Slovak, Argentine, Romanian, 2002 Canada), 7(9) (Austria, China, Hungary, India, 2002 United States), and via note in most recent DTAs (2003 United Kingdom, Mexico, and Russia).

186 1936 Act Part III, Subdivision C of Division 2.

187 Eg art 7(1)(b) of DTAs with Philippines, Papua New Guinea, Thailand, Sri Lanka, Fiji, Kiribati, India, Indonesia art 7(1)(b) and (c), Argentina and Mexico.

188 In art 7(2) of most Australian DTAs the words “. . . or with other enterprise with which it deals” are included at the end of the paragraph to ensure that the “arms-length dealings” test applies between permanent establishments and in art 7(3), in relation to expenses the additional words “of the enterprise” are inserted (for clarity) as are the words “. . . and which would be deductible if the permanent establishment were an independent entity which paid those expenses” (to restrict deductions to those allowed under Australian law).

The meaning of the word “enterprise” in the business profits article was considered in *Thiel v Federal Commissioner of Taxation* (1990) 21 ATR 531, 544; 90 ATC 4717, 4729. Mc Hugh J that noted that: “profits derived from an isolated activity may constitute the profits of “an enterprise” within the meaning of Art 7. . . . To come within Art 7, however, it is not enough that the carrying on of an enterprise has produced “profits” . . . the profits of the enterprise must be profits from an adventure in the nature of trade: cf *Minister of National Revenue v Tara Exploration and Development Co Ltd* (1972) 28 DLR (3d) 135.” The effect of *Thiel* is that where a non-resident does not have a permanent establishment, then capital gains made in respect of assets held in Australia will not be taxable under the business profits article.

The definition of “permanent establishment” in Article 5 of Australian DTAs¹⁸⁹ varies from the OECD Model Convention¹⁹⁰ in that Australia reserves the right to deem a permanent establishment if:

- designated supervisory activity is conducted for more than 12 months;¹⁹¹ and
- “substantial equipment” is being used in association with a project.¹⁹²

A number of variations also exist such as the inclusion of additional attachment rules that deem a permanent establishment where there is “an installation, a drilling rig or ship used for exploitation of natural resources”.¹⁹³

(d) *Summary*

From the above examination it is evident that where a DTA exists, the domestic law is overridden (by allocation of taxing rights) with the deemed source of business income being generally with the country in which the non-resident resides. The major exceptions are where the enterprise is carried on through a permanent establishment, or it is

189 The meaning of the words “branch”, “agency”, “management”, “fixed place of business” and “factory” see *Case 110 5 CTBR(NS)* 656, 667-70; *Case F 85* (1955) 6 TBRD 483, 494-496. Also see *AAT Case 8775* (1993) 26 ATR 1056; *Case 23/93 93 ATC* 288 where a share broker used by a non-resident for trading was a permanent establishment in terms of art 4(5) of New Zealand DTA.

190 A permanent establishment is more widely defined under s 6(1) of the 1936 Act (eg the permanent establishment need not be fixed). The definition operates for the purposes of the 1936 Act in respect of s 23AH (foreign branch profits exemption), s 6C (source of royalty income), Div 11A of Part III (withholding tax), Div 13 of Part III (transfer pricing) and s 432 (re CFC active income test).

For the Commissioner’s view of the phrase “a place at or through which the person carries on any business” in s 6(1) see Taxation Ruling TR 2002/5, *Income Tax: Permanent Establishment – What is ‘a place at or through which [a] person carries on any business’ in the Definition of Permanent Establishment in Subsection 6(1) of the Income Tax Assessment Act 1936?*

191 2003 OECD Commentary on Article 5, para 46. However in many DTAs the period is 6 months (eg art 5(4)(a) of DTAs with Canada and Argentina). Consultancy and management services will also constitute a permanent establishment in some DTAs if connected with a project for more than 183 days in any 12 months (eg DTAs with Argentina art 5(4)(b)). The Commissioner has ruled that a non-resident head contractor of a building project, despite not undertaking any direct work, has a permanent establishment as the supervisory role, as illustrated by legal obligation and risk of the project, lay with the company – see ATO Interpretative Decision ATO ID 2002/850, *Permanent Establishment*.

192 2003 OECD Commentary on Article 5, para 46. A permanent establishment will exist if ‘substantial equipment’ is being used by or under a contract (eg art 5(4)(c) in DTAs with New Zealand and Argentina).

193 Eg, DTAs with China, Spain, and Indonesia. Also under art 5(3)(ii) DTA with India a permanent establishment is deemed to exist on the provision of services through an employee to an associated entity. For a fuller explanation of the differences see Tan How Teck, ‘Some aspects of a permanent establishment in Australia’ (1998) 1 *Journal of Australian Taxation* 151 and Sadiq, above n 170, 14-21.

shipping or insurance income. In these circumstances Australia preserves its source taxing rights under its DTAs.

4 *Capital receipts*

The final category of source principles to be reviewed is the process that determines the source of income from disposals of capital assets.

(a) *Domestic law*

The CGT rules do not contain specific source rules. However, by prescribing the assets (ie, those assets that have "necessary connection with Australia"), owned by non-residents for which Australia retains taxing rights, these "sufficient connection" rules act as a source rule.¹⁹⁴ The assets included in the list are land (interests in land), a building, structure or stratum unit, assets used in carrying on a business through a permanent establishment, a share in a resident private company, an interest in a resident trust, a ten percent by value share or unit in a public company/resident trust owned (directly or indirectly) at any time during the last five years before the CGT event happens, and an option to acquire the above assets.¹⁹⁵

194 1997 Act Div 136, in particular s 136–25. Australia also reserves the right to tax persons on capital gains either when they become non-resident or upon later disposal of assets "necessary connection with Australia" (see 1997 Act ss 104-160(3), 104-165(2)) and 104-165(3)). The Treasurer announced (Treasurer, 'Review of International Tax Arrangements' (Press Release No 32, 13 May 2003), Attachment F) that the Government would not proceed with the Review of Business Taxation recommendation (Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999), Recommendations 22.20) that if departing residents defer CGT until actual disposal of the assets, they should provide a security against payment of the future gains tax liability. The Government accepted that to proceed with this measure would involve considerable compliance, complexity and enforcement burdens for little revenue gain, and would be inconsistent with the thrust of the facilitative expatriate measures and inconsistent with the direction the Government is moving in tax treaty negotiations. It is noted that under the recent protocol to the United States DTA (arts 13(5) and (6)) deferred capital gains tax liabilities will not arise for Australian residents who become residents of the United States, thus removing the need for a security – see Michael Rigby, 'The Protocol to the Australia-United States tax treaty: Part 2' (2003) *Australian Tax Review* 206, 212-15.

195 It is argued that the 'sufficient connection' is a de facto territorial source rule that limits the range of taxable gains in respect of Australian sourced assets – Hamilton, above n 3, para 2.670.

(b) *Impact of DTAs*

Article 13 of the OECD Model Convention provides that gains arising from the alienation of immovable property (as defined in Article 6) will be taxed by the laws of the country in which it is situated¹⁹⁶ as will gains on shares, where 50 percent of their value is in immovable property in that country.¹⁹⁷ Gains from the alienation of moveable property that is a business asset of a permanent establishment (and the alienation of the permanent establishment), will be taxed in the country where the permanent establishment is situated.¹⁹⁸ However, gains arising from alienation of ships and aircraft used for international traffic will be taxed in the country where the effective management of the operator is situated.¹⁹⁹ All other gains are taxable in the country of residence.²⁰⁰

All Australian DTAs entered into since 1985 differ from the OECD Model in that they recognise primacy of source country taxation in respect of gains arising from the disposal of assets.²⁰¹ Thus, Article 13 in Australian DTAs ensures that the domestic capital gains laws of each country will have precedence where the income is not expressly dealt with under the DTA. The purpose of the clause is to ensure that Australia's right to tax capital gains (not the subject of Article 13) is not indirectly overridden by the operation of the Business Profits or Other Income Articles making such gains tax free.²⁰² Also, the DTAs preserve Australia's right to tax assets connected with Australia owned by former residents.²⁰³ There are also terminology differences.²⁰⁴

196 OECD Model Convention, art 13(1).

197 Ibid, art 13(4).

198 Ibid, art 13(2). This is consistent with the rules taxing business profits contained in Article 7.

199 Ibid, art 13(3). This is consistent with the rules taxing profits from operating ships and aircraft in art 8.

200 Ibid, art 13(5).

201 Eg see art 13(5) (unless otherwise specified) in DTAs with United Kingdom art 13(6), United States art 13(7), Canada, New Zealand, South African art 13(4), Romania, Russia and Mexico. Also, Australia specifically reserves the right to tax gains from a wider range of property than specified in the first three paragraphs of Article 13 of the OECD Model – see 2003 OECD Commentary on Article 13, para 33. Similarly, The Government in 2000 introduced s 3A of the *International Tax Agreements Act 1953* (Cth) to ensure indirect disposals of property after 27 April 1998 will not escape the operation of Article 13 in older DTAs.

202 It has argued since 1990 following the decisions in *Theil v Federal Commissioner of Taxation* (1990) 171 CLR 338; 21 ATR 531; 90 ATC 4717 (see Tim Flahvin, 'Non-residents, capital gains tax and double tax agreements' (1991) 3(1) *The CCH Journal of Australian Taxation*, 48) and with more vigour with the 1997 decision in *FCT v Lamesa Holdings BV* (1997) 36 ATR 589; 97 ATC 4752 that many older DTAs appear to be limited to "direct" interests in the real property, allowing capital gains made through indirect holding to escape Australian taxation.

(c) Summary

Where a CGT asset connected with Australia is disposed of by a non-resident, Australia seeks to tax that gain. This is reflected in Article 13 of Australia's DTAs which ensures that Australia's right to tax capital gains is not indirectly overridden by the operation of the Business Profits or Other Income Articles making such gains tax free.

5 Observations

From the exhaustive study above, all that can be deduced is that at common law the factors, which determine the source of business income in any circumstance, will depend on which of the factors are dominant, ie those which indicate the true source of the income (eg location of business or assets or the place of contract). These rules are modified by two statutory source rules which deem an Australian source for shipping and insurance income and the CGT rules which reserve a taxing right in respect of assets connected with Australia. There are also two specific income allocation rules which

The Full High Court in *Theil* held that where a non-resident does not have a permanent establishment, then capital gains made in respect of assets held in Australia would not be taxable under the "business profits" DTA article. Similarly, the Full Federal Court in *Lamesa Holdings* held that under the Netherlands-Australia DTA the capital gains tax rules apply to "direct" interests in the real property only, allowing capital gains made through indirect holding to escape Australian taxation.

Thus, for pre-CGT DTAs it is argued that the taxing rights over a non-resident's capital gains are allocated exclusively to the country of residence thereby eliminating liability to Australian tax (see See John Abrahamson, 'Going Dutch' (1998) 32 *Taxation in Australia* 432, Robert Deutsch and Nolan Sharkey, 'Australia's capital gains tax and double taxation agreements' (2002) 56 *Bulletin for International Fiscal Documentation* 228, Ian Gzell, 'Treaty-shopping' (1998) 27 *Australian Tax Review* 65, Ian Gzell, 'Treaty protection from capital gains tax' (2000) 29 *Australian Tax Review* 25, Hamilton, above n 3, paras 6.682-6.688, Dianna Lane, 'Australia's double tax agreements: Gains from the sale of shares by non-residents' (1999) 2 *Journal of Australian Taxation* 3).

Further, the s 3A amendments to the *International Tax Agreements Act* (ibid) may be ineffective as the legislative changes are inconsistent with wording of many older DTAs, many of which do not deal with capital gains. Further, the changes may not be enforceable, as not all treaty partners have agreed with this unilateral alteration to terms of their existing DTAs (see para 180 of the Taxation Ruling TR 2001/12, *Income Tax and Capital Gains Tax: Capital Gains in Pre-CGT Tax Treaties* in which the Commissioner acknowledges "Norway's preliminary position is that taxes on capital gains are not covered by its treaty with Australia"). The Commissioner's view on the effectiveness of these amendments (in TR 2001/12) is not widely accepted (see eg, Gzell (2000), ibid).

203 Eg see art 13(5) (unless otherwise specified) in DTAs with United Kingdom art 13(6), United States art 13(7), Canada, New Zealand, Romania, Russia and Mexico.

204 As with Article 6 the terms "property" and "real property" are used in preference to "movable property" and "immovable property" as per Australia's reservation – see 2003 OECD Commentary on Article 13, para 33.

deem an Australian source where business is carried on partly in and partly out of Australia or where a business is controlled off shore.

Where a DTA exists, the domestic law is overridden (by the allocation of taxing rights) with the deemed source of business income being generally with the country in which the non-resident resides, except where the enterprise is carried on through a permanent establishment, it is shipping or insurance income or it is an asset connected with Australia under the CGT provisions.

E. Income from property

1 What constitutes income from property?

Income from property is the receipts received for allowing a person to use another person's property. Income from property is usually categorised as interest, dividends, royalties, and lease income. Income from property does not traditionally include business income, where the business involves active dealing with property assets (professional investor), or capital gains from the sale of property.

In this context characterisation is an important issue, as the classification of income as being in one income category rather than another will give rise to the application of different principles for determining territorial source. However, the implications of characterisation are less important in respect of the assessment of interest and dividends, as the tax treatment has been modified by the debt and equity rules in Division 974 of the 1997 Act.²⁰⁵

205 The rules, which have had application from 1 July 2001, were introduced by the *New Business Tax System (Debt and Equity) Act 2001*(Cth). This Act was the first tranche of comprehensive legislative scheme for the taxation of financial arrangements (Taxation of Financial Arrangements (TOFA)). This reform process has been on the Australian agenda since the 1992-93 Budget. The new debit/equity rules were introduced in conjunction with a new thin capitalisation regime (*New Business Tax System (Thin Capitalisation) Act 2001*(Cth)). Tranche two of TOFA, which consists of rules that remove the taxing point at conversion or exchange of certain financial instruments and, more importantly, measures dealing with foreign currency translation and the taxation of foreign exchange gains and losses, was contained in the *New Business Tax System (Taxation of Financial Arrangements) Act (No 1) 2003* (Cth). Tranches three and four of TOFA (which encompassed in these tranches are the reform of the taxation of commodity (eg gold and cotton) hedging and the final stage includes implementation of new tax-timing arrangements, including: a market-to-market election, an accruals/realisation framework, internal hedging rules, disposal rules, and synthetic arrangements) are scheduled for operation from 1 July 2005.

These rules classify financial arrangements into “debt” interests, “equity” interests, “non-share equity” interests and “non-equity” shares based upon the substance of the arrangement, not its legal form.²⁰⁶ “Non-share” equity is an interest in a company which is not legally a share, but is classified as equity for tax purposes, while “non-equity” shares are shares that are classified as debt (eg a redeemable preference share). These classifications do not override the legal character of the arrangement for all purposes of the 1997 Act.²⁰⁷ Thus, if a financing transaction has the legal form of a lease, but is a “debt” interest under these rules, all the specific leasing provisions continue to apply (eg 1936 Act Division 16D).

Therefore, in addressing the processes for determining the source of interest, dividends, royalties and real property income, a brief description of what is classified as income under each of the categories will be undertaken. Having characterised the “income”, an examination of the applicable domestic statutory source rules and the principles used to determine source under common law will be undertaken before exploring the extent to which these rules are overridden by Australia’s DTAs.²⁰⁸

206 They are classified under a debt test (1997 act s 975-2) and equity test (1997 Act s 975-75). A transaction will be debt if it satisfies both the debt and equity tests (1997 Act ss 974-5(4) and 974-70(1)). A “debt” interest is defined in 1997 Act ss 974-15 to 974-65 and an “equity” interest is defined in ss 974-70 to 974-95. An “equity” interest only arises where there is an interest in a company or entity taxed as a company.

207 The debt and equity rules impact upon imputation, the assessment and deductibility of interest/dividend payments, the CGT rules, the withholding tax rules, foreign tax credits and the thin capitalisation rules. They stop the franking of payments arising from “non-equity” shares and permit franking of payments made in connection with “non-share” equity (1997 Act ss 202-45(d), 208-30 and 215-10 to 215-25).

Companies are denied deductions of payments in respect of “non-equity” shares (1997 Act s 26-26), but allowed deductions for payments arising from “non-share” equity (1997 Act s 25-85 and 1936 Act s 82LA). In respect of assessability see 1936 Act s 43B.

The rules ensure that the capital gains treatment mirrors the income tax treatment eg ensure that “non-share” equity and options over these is treated the same as shares and options over shares and introduce convertible interest rules.

The withholding tax rules treat payments of dividends on “non-equity” shares as interest and payments from “non-share” equity as dividends (1936 Act ss 128A(1), 128A(1AB), 128B(2D) and 128B(3)).

The thin capitalisation rules disallow “debt deductions” (as classified under the debt equity rules) where the entities actual debt exceeds the maximum allowable debt (as calculated under the debt equity rules). For further details see Robert Deutsch et al, *Australian Tax Handbook 2004* (2004), Ch 25.

208 The exempt income rules relating to interest, dividend and royalty income sourced in a specified Norfolk Island (1936 Act ss 24J and 24L) will not be examined.

2 Interest

The first category of property income is interest which is generally assessable income according to ordinary concepts under the 1997 Act.²⁰⁹

(a) *The definition of interest*

As the term “interest” is not generally defined in the income tax legislation, the common law definition is often used for characterisation. At common law “interest” is a payment for using another person’s money.²¹⁰ Interest may arise from voluntary agreements (such as a loan), as a component of compensation provided by the government for compulsory acquisition of property or part of a court’s award for damages.²¹¹ It will not include bill discounts and may not include guarantee payments.²¹²

However, as discussed above, payments arising from hybrid instruments, which are classified as debit under the debt/equity rules, will be assessed as if they are interest, although they are not generally legally characterised as “interest”. Under the broad statutory definition of interest for withholding tax purposes such payments are defined to be interest.²¹³ This wider definition varies from the definition under Article 11(3) of the OECD model and the definitions adopted in a number of Australian DTAs.²¹⁴

209 1997 Act s 6-5.

210 Lord Wright in *Riches v Westminster Bank* [1947] AC 390, 400 “[T]he essence of interest is that it is a payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had had the use of the money, or conversely the loss he suffered because he had not that use. The general idea is that he is entitled to compensation for the deprivation.” It is “money paid for the use of money lent or for not exacting repayment of debt” – JB Sykes (ed), *The Concise Oxford Dictionary* (6th ed 1976).

211 For example see *Federal Wharf Co Ltd v Federal Commissioner of Taxation* (1930) 44 CLR 24; 1 ATD 70 and *Whitaker v Federal Commissioner of Taxation* (1998) 38 ATR 219; 98 ATC 4285.

212 Hamilton, above n 3, paras 4.60 and 4.70. However, such amounts are caught with the expanded withholding tax definitions in 1936 Act, Division 11A. Also excluded at common law are amounts received by lender under an “indemnification of tax” clause – *Federal Commissioner of Taxation v Century Yuasa Batteries* (1998) 38 ATR 442; 98 ATC 4380.

213 “Interest” is defined in the 1936 Act s 128(1AB) to include amounts (other than a prescribed security (1936 Act s 26C(1))) that are in the nature of interest, is a substitute for interest or subject to a wash arrangement and is a dividend in respect of non-share equity.

214 “Interest” is defined in art 11(3) of the OECD Model to “. . . mean income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purposes of this Article.” In many DTAs interest in the nature of dividend (under art 10) is expressly excluded from the

(b) *Statutory source of interest rule*

Interest is deemed to have an Australian source where the monies are secured by mortgage on an Australian property under s 25(2) of the 1936 Act.²¹⁵ Excluded from this test is interest paid outside Australia to a non-resident on debentures issued outside Australia by a company.²¹⁶ Also, the withholding tax rules give an Australian origin to payments by Australian residents and, in the case of interest, by non-residents carrying on business in Australia.²¹⁷

(c) *Common law*

Outside the narrow statutory origin and source rules, the process for determining source is set out in the common law. There are a number of factors that indicate the source of interest income, including the place:

- the contract was made;
- the money was lent;
- where a lender is incorporated; and
- where the lender's business is carried on.²¹⁸

definition of interest (eg United States, and United Kingdom DTAs) as is interest arising from shipping or airline (art 8) enterprises (eg Argentina DTAs).

215 This rule is one of the older type of source rules deriving from the s 3 definition of "income" in the 1915 Act. The 1915 Act s 3 definition of "income" was incorporated into the 1922 Act (s 4(a) and with the s 16(b) exception for non-resident debentures) before being incorporated into the 1936 Act s 25(2).

216 To satisfy the test it was sufficient that part of the security is in Australia and does not matter that, apart from 1936 Act s 25(2), the source of income would not have been Australia - see *Broken Hill South Limited v Commissioner of Taxation (NSW)* (1937) 56 CLR 337; 1 AITR 106; 4 ATD 163. Also see Magney, above n 138, 37

217 Australia's withholding tax rules are found in the 1936 Act Part III, Div 11A. Withholding tax is paid by the lender on behalf of a non-resident. The rules cover payments from resident to non-resident (ss 128B(2)(B)(1) and 128B(6)) and payments to non-residents by a non-resident through a permanent establishment (ss 128B(2)(b)(1) and 128B(7)). It is a final tax (s 128D). Interest to which s 128B applies is liable to tax at the rate of 10% - see *Income Tax (Dividends, Interest and Royalties Withholding tax) Act 1974* (Cth), s 7(b) and *Taxation Administration Regulations 1976* (Cth), reg 41. There are a series exemptions including under where the interest is exempt or it is assessable to trustee under ss 99, 99A or 102, being derived by non-resident conducting business through permanent establishment (s 128B(3)), is in respect of offshore banking units (s 128GB) or arises from widely distributed debentures (s 128F) - see Emaneul Hiou, 'Withholding tax developments are of real interest' (1998) 1 *Journal of Australian Taxation* 180.

218 *Spotless Services v Federal Commissioner of Taxation* (1993) 25 ATR 344, 359-60; 93 ATC 4397, 4410 (Lockhart J), above n 155. Also see Trevor Johnson, 'UK Tax Update: Sauce for the goose is sauce for the gander' (2004) 33 *Tax Notes International* 361, 363 who notes that other factors such

Factors such as the situs of the debt,²¹⁹ residence of the debtor²²⁰ and the location of fund utilisation²²¹ carry little weight.²²² Where the loan is unsecured, the place of contract can be crucial²²³ as is the provision of credit.²²⁴

In the end, the source of interest is determined by weighing all the above factors, with the factors surrounding the making of the loan carrying a heavier weighting.²²⁵

(d) *Impact of DTAs*

Under Article 11 of the OECD Model the right to tax interest is shared with the primary right assigned to the country of residence, with the country where the “interest arises” (ie origin) having a limited right to tax interest (usually 10 percent of the gross interest) of the non-resident “beneficial” owner.²²⁶ Generally, interest is deemed to arise in a country where the payer is resident, except where a payer has a permanent establishment.²²⁷ The article does not include interest arising from a business conducted through a permanent establishment in the country of source (which is dealt with under Article 7).²²⁸ Where transfer pricing results in interest overpayment, only the “market” interest is subject to Article 11.²²⁹

as residence of the debtor, source from which interest was paid, place interest paid and the nature and location of security have been found to be important in other United Kingdom decisions.

219 However, if the loan arises from the conduct of a business the source of the loan may be the place of business - *Commissioner of Inland Revenue v Hang Seng Bank Limited* [1991] 1 AC 306.

220 For a simple loan residence of the debtor was important – *ES & A Bank v Inland Revenue Commissioner* [1932] AC 238.

221 Utilisation of funds was not important in *Commissioner of Inland Revenue (NZ) v NV Philips Gloeilampenfabrieken* [1955] NZLR 868; (1954) 10 ATD 435.

222 Hamilton, above n 3, para 2.630, Magney (1997), above n 26, 16.

223 *Webb v Campbell* (1900) 25 VLR 506, *Spotless Services v Federal Commissioner of Taxation* (1993) 25 ATR 344, 359-60; 93 ATC 4397, 4411; *Studebaker Corporation of Australia Ltd v Federal Commissioner (NSW)* (1921) 1929 CLR 255; R & McG 165 and *Commissioner of Inland Revenue (NZ) v NV Philips Gloeilampenfabrieken* [1955] NZLR 868; (1954) 6 AITR 158; 10 ATD 435. Also see Magney (1997), above n 26, 11 notes that source of derivative income is more likely to be at the place the master agreement is made.

224 *Commissioner of Inland Revenue (NZ) v NV Philips Gloeilampenfabrieken* [1955] NZLR 868; (1954) 6 AITR 158; 10 ATD 435; and *Commissioner of Inland Revenue v Lever Bros and Unilever Ltd* [1946] SAfPC 1. Also see Philip Crutchfield and Peter Willis, ‘Australian tax treatment of non-residents’ (1991) 18(7) *Tax Planning International Review* 24, 25.

225 Magney (1997), above n 26, 16.

226 OECD Model arts 11(1) and (2).

227 Ibid, art 11(5).

228 Ibid, art 11(4). DTAs with an Independent Services Article (art 14) also direct that interest arising in relation to those activities be dealt with under art 14.

229 Ibid, art 11(6).

Article 11(1) is adopted in most Australian DTAs. However, the rate of withholding by the “source” country is not always 10 percent, varying between zero and 25 percent.²³⁰ The *International Agreements Act 1953* (Cth), s 16 provides non-residents with a rebate for Australian tax levied in excess of the amount of tax payable in the DTA (ie in respect of any tax raised in excess of the 10 percent limit). There are also terminology differences between the Australian DTAs and the OECD Model.²³¹ The interest withheld is deemed, in most DTAs under the “source of income” Article to have an Australian source.²³²

(e) Overview

In summary, the source of interest under Australia’s domestic law will be determined by weighing a number of factors with the factors surrounding the making of the loan (ie the place of contract) carrying a heavier weighting. However, where the lender is a non-resident an origin tax of 10 percent is levied regardless of source.²³³ This withholding is permissible under all Australian DTAs, and the interest has an Australian source.

3 Dividends

The second form of property income is a dividend. Under the 1936 Act, dividends derived from profits are assessable where paid to a shareholder.²³⁴ However, a non-resident is only assessable on dividends paid by a company to the extent to which they are paid out of profits derived by the company from sources in Australia.²³⁵ Similar

230 The rate of withholding is generally 10 percent. A 12 percent withholding rate is provided for in DTAs with Argentina, a 15 percent withholding rate with India, Korea, Malaysia, Malta, and Mexico (on non-finance industry interest which is taxed at 15 percent), and Philippines, and a 10 to 25 percent withholding rate with Thailand. In some cases Government reserves are only taxable in that country (eg United Kingdom, United States and Mexico DTAs).

231 Eg, the term “debt claims” is not used in Australia DTAs. See generally Magney (1994), above n 27, 57-65.

232 See above n 27.

233 Asprey Report, above n 10, 278.

234 1936 s 44(1)(a)(i).

235 1936 s 44(1)(b)(ii). This is also an older source rules deriving from ss 16(b)(i), 16B, and 16AA(1) of the 1922 Act, before incorporation in the 1936 Act. Also see *Parke Davis & Co v Federal Commissioner of Taxation* (1959) 101 CLR 521; 7 AITR 421; 11 ATD 545.

rules apply for non-share dividends, but these do not need to be paid from profits.²³⁶ The withholding tax rules give an Australian “origin” to dividend payments made by Australian residents to non-residents.²³⁷

(a) *The definition of a dividend*

A dividend is defined by a series of sections to include an amount (either money or property, including shares) that is distributed (made, paid, credited or issued) to a person (a shareholder) by a company in return for that person investing in the company via share capital.²³⁸ The “amount” distributed usually consists of profits, including profits capitalised by the company, but does not include returns of capital.²³⁹

There is also a specific definition for withholding tax purposes, which encompasses the debt/equity classifications,²⁴⁰ and under Article 10(3) of the OECD Model, which has been incorporated into Australia’s DTAs.²⁴¹

This rule is wide, potential capturing dividends passing between two non-resident entities, where the paying entity has received an Australian dividend. This was a problem under the art 10(5)(c) of 1982 United States DTA, which stated that Australia can impose tax on dividends paid by a United States resident company if the dividends are paid out of profits from a permanent establishment of the company in Australia, the gross income attributable to such permanent establishments constitutes at least 50 percent of the US company’s gross income and Australia does not impose branch profits tax as described in art 10(6). This problem continues for dividends paid to shareholders in non-DTA countries as *International Tax Agreement Act 1953* (Cth) s 18 does not apply as it only operates where a DTA exists.

236 1936 s 44(1)(a)(ii) and (b)(ii).

237 Australia’s withholding tax rules for dividends are found in the 1936 Act Part III, Div 11A. They are not applicable to the extent to which a dividend that has been franked in accordance with s 204-30(3)(c) of the 1997 Act (1936 Act s 128B(3)(ga)). The current withholding tax rate is 30% or 15% - see *Income Tax (Dividends, Interest and Royalties Withholding tax) Act 1974* (Cth), s 7(a) and *Taxation Administration Regulations 1976* (Cth), reg 40. An exempt from dividend withholding tax exists to the extent that the dividend consists of an amount debited from the resident company’s foreign dividend account (1936 Act s 128S to s 128TF).

238 1997 Act, s 995-1 defines a “dividend” as having the meaning given by 1936 Act ss 6(1)(4) and (5) and 6BA(5) and 94L and 1997 Act s 375-872. Ratcliffe, above n 42, 181 notes that in absence of such provisions the source of a dividend would be determined by the contract between the company and the shareholder.

239 1936 Act, s 6(4). It also includes concessional capital issued by a “film licensed investment company” (FLIC) in lieu of a dividend – 1997 Act s 375-872. Also see *Thornett v Federal Commissioner of Taxation* (1938) 59 CLR 787; 1 AITR 327; 4 ATD 551.

240 The definition in 1936 Act s 128A(1) incorporates the other definitions of dividends but expressly excludes dividends arising from non-share equity. The withholding tax rules also apply to non-share equity, except under 1936 Act ss 128AE, 128F, 128J and 128K - see 1936 Act s 128AAA.

241 Under Article 10(3)) a dividend is defined to be “. . . income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the state of which the company making the distribution is a resident.”

(b) *Statutory source of dividends rule*

Section 44(1) of the 1936 Act states that the source of a dividend paid to a non-resident is the source of the profits from which the dividend has been paid.²⁴² The process for determining “source of profits” is determined under the common law (see below).

The other limited statutory source rule is found in the *International Tax Agreements Act 1953* (Cth). It provides that for all countries with which Australia has a DTA the dividend shall be deemed to be sourced in the country of residence of the non-resident company paying the dividend provided the dividend is taxed in that country and there is not an inconsistent provision in the relevant DTA.²⁴³

(c) *Common law*

With dividends there has always been the question of whether the source of a dividend is where the profits are derived which gives rise to the dividend paid, or where the share register is located.²⁴⁴ In *Esquire Nominees Ltd v Federal Commissioner of Taxation*²⁴⁵ the full High Court found that *prima facie* the source of the income was dictated by the location of the share register.²⁴⁶

The Article 10(3) definition as adopted in Australian DTAs is less prescriptive, merely defining dividends to be “. . . income from shares and other income assimilated to income from shares by the law, relating to tax, of the Country of which the company making the payment is a resident.”

The definition of dividend is deemed, by s 3(2A) of the *International Tax Agreements Act 1953* (Cth), not to apply from 5 December 2003 to debt interests as defined in the debt and equity rules.

242 *Parke Davis & Co v Federal Commissioner of Taxation* (1959) 101 CLR 521; 7 AITR 421; 11 ATD 545. This reflects the outcome in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183; R & McG 14. However, the Act is silent in determining “. . . the source of a dividend, where it is part of the profits from which a dividend is paid to a non-resident – see Asprey Report, above n 10, 278.

243 *International Tax Agreements Act 1953* (Cth) s 18(1) and (2).

244 The place profits were paid approach was developed in *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183; R & McG 14.

245 *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177; 73 ATC 4114; 4 ATR 75. It followed the earlier decision of *Freeman v the Commissioner of Taxation (NSW)* (1956) 6 AITR 225; 11 ATD 21.

246 *Esquire Nominees Ltd v Federal Commissioner of Taxation* (1973) 129 CLR 177, 211-12; 73 ATC 4114, 4117; 4 ATR 75, 79, Barwick CJ noted “[p]rima facie it seems that the place where the distributed profits were made is the geographical source of the fund out of which the dividend itself is declared: therefore it may be said that place is the geographical source of the dividend.” However, before determining that source, Barwick CJ noted “. . . the location of the fund of profits which is distributed by means of the dividend is the place where they are made . . . In some cases real difficulties may be met in deciding the point of geographical location, where the relevant profits of a company were made. But it is a question of fact to be determined on all the facts and circumstances in each particular case.”

(d) *Impact of DTAs*

Although under Article 10 of the OECD model²⁴⁷ both the country of shareholder residency and the country where the company resides have the right to tax dividends, the country of company residence has a limited right to tax (between five and 15 percent) dividends received by a beneficial owner²⁴⁸ of the shares resident in the other country.²⁴⁹ As with Article 11, Article 10 does not include dividends arising from a business conducted through a permanent establishment in the country of source (which is dealt with under Article 7).²⁵⁰

Articles 10(1) and (2) are adopted in most Australian DTAs; however, the rate of withholding by “origin” country varies between zero and 25 percent.²⁵¹ There are also terminology differences between the Australian DTAs and the OECD Model.²⁵² The

247 For a history of Article 10 see Peter Harris, ‘Origins of the 1963 OECD Model Series: Working party twelve and Article 10’ (2000) 15 *Australian Tax Forum* 3.

248 For a discussion of the term “beneficial owner” see JDB Oliver et al, ‘Beneficial ownership and the OECD Model’ [2001] *British Tax Review* 27.

249 OECD Model Articles 10(1) and (2).

250 Ibid, Article 10(4). DTAs with an Independent Services Article (Article 14) also direct that interest arising in relation to those activities be dealt with under Article 14.

251 The most common rate in pre-1995 DTAs is 15 percent, with the rate varying depending upon level of economic development of the treaty partners (ie if a developing capital importing country the rate will be higher, eg 20% in Fiji, Papua New Guinea and Thailand and 25% in Philippines). This was supported by a reservation by Australia permitting taxation of dividends at no-less than 15 percent. These DTAs did not factor in the impact of dividend imputation – see Richard Vann, ‘Australia’s new treaty policy: Noise or music?’ (Paper presented at the Taxation Institute of Australia’s New South Wales Division’s International Masterclass, Sydney, 22 July 2003), 2. In post 1995 DTAs (starting with the DTA with the Czech Republic) the rate of withholding does vary from 15 percent depending upon the:

- level of share ownership - the rate is lower for dividends arising from non-portfolio shares (eg in DTAs with the United Kingdom, United States, Canada, Romania, and Russia (slightly different conditions - a rate of 5% applies where voting power exceed 10%; 10% tax under Argentina DTA) and where the non-resident shareholder, a publicly listed company, owns in excess of 80 percent of the paying company (eg in DTAs with the United Kingdom and United States (although slightly different criteria) dividends are exempt in country of company residence); and
- character of the income (eg under New Zealand DTA art 10(2) a dividend to arise from the business of life insurance is subject to a maximum rate of tax of five percent).

252 Eg, the term “beneficially entitled” is used in Australian DTAs in preference to the term “beneficial owner”. The term “beneficial owner” is used in DTAs with the United Kingdom. See generally Magney (1994), above n 27, 53-57; Michael Rigby, ‘The Protocol to the Australia-United States tax treaty: Part 1’ (2003) 32 *Australian Tax Review* 135, 147-159 and Anne O’Connell, ‘The Race for Tax Base: Allocation of Taxing Rights between Source and Residence Jurisdictions in Australia’ (2001) 24 *Tax Notes International* 1003, 1007. Australia also does not provide for mutual agreement to settle application of the taxing limitations under Article 10(2).

amount withheld is deemed, in most DTAs under the “source of income” Article to have an Australian source.²⁵³

(e) *Overview*

In summary, the source of a dividend under Australia’s domestic law will be determined by weighing a number of factors with the location of the share register carrying a heavier weighting. However, where the shareholder is a non-resident the level of franking will determine the level of origin tax. The withholding tax ranges from exemption for fully franked dividends being tax free to unfranked dividends being subject to an origin tax of 30 percent.²⁵⁴ This withholding is permissible under all Australian DTAs; however, the rate of origin tax is limited on unfranked/partial franked dividends to rates of tax ranging between zero to twenty-five percent (depending upon the particular DTA).

4 *Royalties*

The third category of property income is a royalty. A royalty is assessable under s 6-5 of the 1997 Act where it is income under ordinary concepts. Where it is not income under ordinary concepts, it is assessed under s 6-10 (via s 15-20) of the 1997 Act. Section 15-20 of the 1997 Act includes anything that falls within the ordinary meaning of the term “royalty” (excluding royalties as defined in s 995-1 of the 1997 Act), but is not assessable under s 6-5 as ordinary income.²⁵⁵ Withholding tax rules give an Australian origin to royalty payments by Australian residents to non-residents.²⁵⁶

253 See above n 27.

254 This withholding is not related to source – Asprey Report, above n 10, 278.

255 As payments deemed to be royalties under s 995-1 of the 1997 Act are expressly excluded from the scope of s 15-20, it is argued that s 15-20 has a narrower scope than the former s 26(f) of the 1936 Act as it does not assess deemed royalties that are not income in nature. Thus, as payments for “know how” (ie technical information) are not royalties at common law (*Sherritt Gordon Mines v Federal Commissioner of Taxation* (1977) 137 CLR 612; 7 ATR 726; 77 ATC 4365), they are not caught under s 6-5 or under s 15-20. This runs counter to the policy of the Tax Law Improvement Project whose task was to rewrite 1936 Act provisions in the 1997 Act. The changes were intended to be a rewrite, involving no major policy changes. However, the 1997 Act seeks to avoid such unintended changes by a direction in s 1-3 that the Courts should construe the legislation in the same way as the former provisions. Section s 1-3 of the 1997 Act is based upon s 15AC of the Acts Interpretation Act 1901. It is not certain that s 1-3 will achieve this in these circumstances, as it is clear that s 1-3 will have no operation where a policy change is intended. The problem for legislators is that s 15-20 of the 1997 Act does contain a policy change in that amounts assessed

(a) *The definition of a royalty*

A “royalty” is defined widely in s 6(1) of the 1936 Act as consideration for the use of, or the right to use a series of rights (of the forbearance to use) or for the supply of ancillary assistance in association with that use.²⁵⁷ A “royalty” at common law is a term applied indiscriminately to describe periodic payments for the right to use an intangible asset. The key characteristics of a royalty at common law are that the:

- payments are made in return for the use of a right or privilege;²⁵⁸
- payments must be made to the owner or person able to confer a right;
- consideration is linked to the amount used;²⁵⁹ and
- consideration is paid as and when the privilege acquired is exercised²⁶⁰ (however, a lump sum will be a royalty where it is a pre estimate of the user's use),²⁶¹

under common law, which were caught under the former s 26(f) of the 1936 Act, are expressly excluded from the scope of s 15-20.

256 Australia's withholding tax rules for dividends are found in the 1936 Act Part III, Div 11A. The current withholding tax rate is 30% - see *Income Tax (Dividends, Interest and Royalties Withholding tax) Act 1974* (Cth), s 7(c) and *Taxation Administration Regulations 1976* (Cth), reg 42.

257 1997 Act s 995-1 incorporates the 1936 Act s 6(1) definition. A "royalty" or "royalties" is widely defined to include any amount paid or credited, however described or computed, as consideration for the use of, or the right to use series of rights or for the supply of ancillary assistance. These rights include:

- any copyright, patent, design or model, plan, secret formula or process, trade-mark, or other like property or right;
- any industrial, commercial or scientific equipment;
- some or all of the part of the spectrum (within the meaning of the *Radiocommunications Act 1992*) specified in a spectrum licence issued under that Act; and
- motion picture films; films or video tapes for use in connexion with television; or tapes for use in connexion with radio broadcasting.

Also covered are similar amounts “paid” for the reception of, or the right to receive, visual images or sounds, or both, transmitted to the public by satellite; or cable, optic fibre or similar technology or use in connection with television broadcasting or radio broadcasting. However, micro-wave technology was left out.

The inclusive of ancillary assistance in the definition was to overcome the problems with the common law definition, which excludes "know how" (ie technical information) from the meaning of royalty (see *Sherritt Gordon Mines v Federal Commissioner of Taxation* (1977) 137 CLR 612; 7 ATR 726; 77 ATC 4365).

258 *McCauley v Federal Commissioner of Taxation* (1944) 69 CLR 235; 3 AITR 67; 7 ATD 427.

259 In *McCauley* a dairy farmer sold the right to cut and remove timber from his farm at a price per 100 superficial feet. High Court held that payment was by way of royalty and assessable. However, in *Stanton v Federal Commissioner of Taxation* (1955) 92 CLR 235; 6 AITR 216; 11 ATD 1 the High Court held that a similar right, sold for a fixed sum unrelated to quantity, was not a royalty.

260 *Stanton v Federal Commissioner of Taxation* (1955) 92 CLR 235; 6 AITR 216; 11 ATD 1.

261 In *Inland Revenue Commissioner v Longmans Green & Co* (1932) 17 TC 272 where an amount was paid in terms of a right to sell a maximum number of books was a royalty, despite being received in a lump sum

but does not include an amount unrelated to use. Payments that do not relate to use include payments for the acquisition of the right to use,²⁶² payments for an exclusive supply agreement (ie a percentage of estimated sales)²⁶³ and payments for “know how”.²⁶⁴ In many cases royalties are difficult to define because some royalties may involve a diminution of the capital asset.²⁶⁵

The term “royalties” is defined more narrowly in Article 12(2) of the OECD Model Convention.²⁶⁶ The 2003 OECD Model Tax Convention Commentary states that the term includes payments for the use of digital product (software, music, film and text) down-loaded electronically, but not payments to acquire the data.²⁶⁷ A broader definition, based upon the expanded categories in the 1936 Act definition,²⁶⁸ is adopted in many Australian DTAs.²⁶⁹

262 *Stanton v Federal Commissioner of Taxation* (1955) 92 CLR 235; 6 AITR 216; 11 ATD 1.

263 *Aktiebolaget Volvo v Federal Commissioner of Taxation* (1978) 8 ATR 747; 78 ATC 4316.

264 *Sherritt Gordon Mines v Federal Commissioner of Taxation* (1977) 137 CLR 612; 7 ATR 726; 77 ATC 4365.

265 For example, where royalties are given to a person for the use of a mine, the exercise of the mining rights generally involves a decrease in the value of the mine because of the extraction of minerals. In this situation, part of the royalty payment is to compensate the mine owner for the decrease in the value of the mine created by the extraction of minerals. In *McCauley v Federal Commissioner of Taxation* (1944) 69 CLR 235, 240; 3 AITR 67, 70; 7 ATD 427, 429 Latham CJ noted that “The word royalty is most commonly used in connection with agreements for the use of patents or copyrights and in relation to minerals . . . [but] is not, however, limited to patents, copyrights and minerals. The term has been used to describe payment for removing furnace slag from land (*Shingle v P Williams & Sons* (1933) 17 TC 574) and to payments for flax cut (*Akers v Commissioner of Taxes* (NZ) [1926] NZGLR 259), the person paying the royalties becoming the owner of the slag or of the flax. In *Commissioner of Taxes (NZ) v Kauri Company* [1913] AC 771; 31 NZLR 617, there is a reference to timber royalties calculated as in the present case, per 100 feet cut.”

266 “Royalties” are defined to be “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”

267 2003 OECD Commentary on Article 12, paras 12.1 to 17. Also see generally Aldo Forgiione, ‘Clicks and mortar: Taxing multinational business profits in the digital age’ (2003) 26 *Seattle University Law Review* 719, 723-3 and Westberg, above n 159, 121-3. However not all countries agree with the OECD definition - see Paul Singleton, ‘Non-resident electronic commerce taxation: An international comparison’ (2002) 10 *Asia-Pacific Tax Bulletin* 162.

268 For the Commissioner’s view see Taxation Ruling IT 2660, *Income Tax: Definition of Royalties* and Taxation Ruling TR 93/12, *Income Tax: Computer Software*. The ATO’s view on software in TR 93/12 is generally consistent with the OECD Commentary – see Jinyan Li, ‘E-commerce Policy in Australia, Canada and the United States’ (2000) 6 *University of New South Wales Law Journal* 40, 43.

269 Unlike the OECD Model the Australian DTAs:

- spells out that the nature of the payments (ie payments or credits, whether periodical or not, or however described or computed; and
- expressly includes know-how (eg “the supply of scientific, technical, industrial or commercial knowledge or information.” This provision encompasses “know how” rather than payments in

(b) *Statutory rules*

There are two source rules applicable to royalties, a general provision and a specific rule for certain “natural resource” royalties.

(i) *Source of royalty income derived by a non-resident*

The general source rule for royalties in s 6C of the 1936 Act operates to override the common law in ascribing in specific provisions of the tax law an Australian source to royalty income.²⁷⁰ Under these provisions a royalty will have an Australian source where it is paid or credited by a resident to a non-resident, unless it is an outgoing wholly incurred by a person in carrying on business in a country outside Australia.²⁷¹ Royalties will also be deemed to have an Australian source if paid or credited to a non-resident by a person who is a non-resident provided it is an outgoing incurred by that payer in carrying on business in Australia through a permanent establishment.²⁷²

respect of a contract for service, being based upon the test used by the German Supreme Court in *Bundesfinanzhof* (No IR 44/67 of 16 December 1970), Under that test, a contract will be for “know how” if it is “. . . one for the supply, for the use by the buyer of a ‘product’ which is already in existence (or substantially so)”, but will be a contract for personal services if it is “. . . one which requires the contractor to apply special skills and knowledge for his own purposes in order to bring the ‘product’ into existence for the ‘buyer’” - Explanatory Memorandum, International Tax Agreements Amendment Bill 1995 (Cth), 34).

Australia’s more recent DTAs include a wider category of items in respect of which the payments will be royalties (similar to 1936 Act s 6(1) definition of royalty), including:

- films or tapes for television and tapes for radio; and
- visual images or sounds, or both, transmitted by satellite, cable optical fibre or similar technologies.

For example, the first category is solely used in DTAs between 1985 and 1995 (and in the recent DTAs with Mexico, United Kingdom and Spain), while both are used in most post 1995 DTAs with Canada, New Zealand, Czech Republic, Taiwan, South Africa, Slovak Republic, Argentina, Romania and Russia.

Ultimately, what is included does vary from DTA to DTA (eg the DTA with United States excludes equipment rentals from the royalty Article).

270 For the purposes of Divisions 5 and 6 of Part III (1936 s 6C(1A)) and s 23(r) of the 1936 Act and ss 6-5 and 6-10 of the 1997 Act (1936 s 6C(1A)).

271 1936 Act s 6C(1)(a). Section 6C was inserted by the *Income Tax Assessment Act 1968* (Cth) to ensure that an Australian source could not be avoided by executing contracts offshore or providing payments offshore (an issue highlighted in *Aktiebolaget Volvo v Federal Commissioner of Taxation* (1978) 8 ATR 747; 78 ATC 4316) - Explanatory Memorandum, Income Tax Assessment Bill 1968 (Cth), 62.

272 1936 Act s 6C(1)(b).

(ii) *Natural resource income royalties*

A “natural resource income”²⁷³ royalty, under s 6CA of the 1936 Act, is deemed to have an Australian source for specific provisions of the tax law.²⁷⁴ Excluded from its scope are royalties derived by a non-resident (resident in a foreign country in respect of which a DTA was in force) pursuant to a continuing entitlement as at 7 April 1986.²⁷⁵

(c) *Common law*

As the statutory rules apply for limited purposes (ie they do not deal with inbound royalties and in respect of foreign tax credits),²⁷⁶ a determination of source under the common law is still important. The crucial factors in determining the source of a royalty at common law are the location of the property²⁷⁷ and for know-how, the contract under which the rights give rise to the income.²⁷⁸

(d) *Impact of DTAs*

Under Article 12 of the OECD Model Convention, royalties are taxed in the state in which the beneficial owner resides, unless the beneficial owner carries on a business in

273 “Natural resource income” is defined in 1936 s 6CA(1) to be income derived by a non-resident and is calculated, in whole or in part, by reference to the value or quantity of natural resources produced, recovered or produced and recovered, in Australia is after 7 April 1986.

274 For the purposes of Divisions 5 and 6 of Part III (1936 s 6CA(2)) and ss 23(r) and 255 of the 1936 Act and ss 6-5 and 6-10 of the 1997 Act (1936 s 6CA(3)).

275 The income also must be in a class of income which the Commissioner, before 8 April 1986, had given a statement in writing to the effect that income tax would be levied on 50 per cent of income – 1936 Act s 6CA(1). The explanation for these later clauses (which were inserted by *Taxation Laws Amendment Act (No 4) 1986* (Cth)) has never been clearly stated. Newspapers have speculated about special tax arrangement in respect of an “override” royalty on oil production from the Base Strait oil fields. The arrangement was put under the public spot light when Weeks Petroleum was purchased by Bell Resources in 1984. Weeks Petroleum (which retained a large percentage of the royalty), along with other owner, had a concessionary tax treatment in respect of the royalty until 2006. As Bell Resources was a corporate raider with an aggressive approach to taxation the Government sought to end the concession and s 6CA was introduced on 7 April 1986. It renders the entire royalty taxable when the beneficial interest changes.

276 Eg under 1936 Act s 160AF(1)(a).

277 *Curtis Brown Ltd (as agent for Stella Brown) v Jarvis* (1929) 14 TC 744 and *International Combustion Ltd v Inland Revenue Commissioner* (1932) 16 TC 532.

278 *James Fenwick & Co Ltd v Federal Commissioner of Taxation* (1921) 29 CLR 164; *R & McG 28, George Kent Ltd v Commissioner of Taxation (NSW)* (1943) 2 AITR 370; 7 ATD 243 and *Premier Automatic Ticket Issuers Ltd v Commissioner of Taxation (NSW)* (1933) 50 CLR 268; 2 ATD 378. In absence to a property right the source was the place of contract in *Federal Commissioner of Taxation v United Aircraft Corporation* (1943) 68 CLR 525; 2 AITR 458; 7 ATD 318. Also see

the country where payment is made through a permanent establishment.²⁷⁹ However, as Australia has traditionally reserved the right to tax royalties on a source basis, Australian DTAs give both the country of source and the country of residence of the beneficial owners the taxing right, with a rate limitation applied to the country of source.²⁸⁰ The rate varies between five and 20 percent with a 10 percent rate applicable in most DTAs.²⁸¹ The amount withheld is deemed, in most DTAs under the Source of Income Article to have an Australian source.²⁸²

Australia also reserves the right to tax income derived from leasing of industrial and scientific equipment as royalties.²⁸³ The variations in the definition of royalty in the OECD Model and the Australian have been discussed above.

(e) *Overview*

In summary, the source of a royalty under Australia's domestic law is to be determined through the operation of two statutory source rules (ss 6C and 6CA of the 1936 Act), for the purposes of certain specific taxing provisions, and for the balance of the tax law, under the common law. The common law weighs a number of factors (such as the nature of the contract, the location of property and the place of payment) in determining source of royalty income. The Australian DTAs share taxing rights, allowing limited taxing to the country of source.

5 *Income from real property*

The final form of property income is lease income. Lease income is the payment for the right to use real (immovable) and personal (movable) property. However, as lease income in respect of personal property may be caught under the extended definition of royalty in

Asprey Report, above n 10, para 17A.19, Dukes, above n 100, 11, and Hamilton, above n 3, para 2.610 and Geoffrey Lehmann, and Cynthia Coleman, *Taxation in Australia* (5th ed, 1998), 1125.

279 OECD Model Convention arts 12(1) and (3).

280 2003 OECD Commentary on Article 12, para 36.

281 The tax rate is five percent in Australia DTAs with United Kingdom and United States, 12.5 percent with Taiwan, 15 percent with Korea, Thailand, Malaysia, Kiribati and Fiji, with split rates operative with Indonesia and Argentina (10 and 15 percent), Philippines (15 and 20 percent) and India (10, 15 and 20 percent).

282 See above n 27.

283 2003 OECD Commentary on Article 12, para 39.

s 6(1) of the 1936 Act, the source of that lease income is determined in terms of the royalty “rules”.²⁸⁴ As the scope of the source rules in respect of royalties have been explored above, this examination of source will focus on lease income arising from real property.

(a) *Domestic law*

There are no statutory source rules for income in respect of real property. At common law, as it is income that derives from immovable property, its source is where the underlying property is located.²⁸⁵

(b) *Impact of treaties*

Article 6 of the OECD Model Convention assigns the taxing rights in respect of income derived from the direct use, letting or use in any other form of “immovable” property to the country in which the property is located.²⁸⁶ Immovable property is defined to include property ancillary to agriculture and forestry.²⁸⁷ The rules also apply to income from immovable property of an enterprise and formerly applied to income from immovable property used for the performance of independent personal services.²⁸⁸

The Australian DTAs vary from the OECD model in terminology²⁸⁹ and the Australian definition of “real property” does not generally include income from agriculture and forestry activities, but does include payments for the direct use, letting or any other use of mineral, oil or gas deposits or other natural resources (including rights to explore for or to exploit mineral, oil or gas deposits or other natural resources) and any payments in

284 Magney (1978), above n 138, 39 and Asprey Report, above n 10, 276) of the 1936 Act.

285 *Federal Commissioner of Taxation v United Aircraft Corporation* (1943) 68 CLR 525, 536; 2 AITR 458, 464; 7 ATD 318, 322 (Latham CJ). Also see Asprey Report, above n 10, 276.

286 OECD Model Convention, arts 6(1) and (3).

287 OECD Model Convention, art 6(2).

288 OECD Model Convention, art 6(4). See Raul-Angelo Papotti and Nicola Saccardo, ‘Interaction of Articles 6, 7 and 21 of the 2000 OECD Model Convention’ (2002) 56 *Bulletin for International Fiscal Documentation* 516.

289 Eg, as the term “immovable property” is relatively unknown in Australian law DTAs use the term “real property”.

consideration for using those rights.²⁹⁰ These interests or rights are deemed to be sourced where the resources are situated or where the exploration may take place.²⁹¹

F. DTA “catch-all”

Finally, for completeness it is important to mention that Article 21 of the OECD Model allocates the taxing rights where the treaty is silent. The Article in Australian DTAs varies from the OECD Model in that income derived by a resident of one country will be taxable in that country of residence, unless it is sourced in the other country. In these circumstances the country of source also has the right to tax. Relief from double tax would be provided by Article 24 that requires the country of residence to provide tax relief.²⁹²

G. Summing up the scope of source

In determining source of income, Australia has a number of ad hoc statutory source and origin rules and relies heavily on the guiding principles emerging from the common law to determine source. This determination of source turns on legal jurisdictional concepts, based on physical or territorial location, and on legal characterisations of income.²⁹³

Having extensively reviewed the scope of the operation of the statutory source rules, the guiding principles emerging from the common law and the extent to which Australia’s

290 Eg, art 6(2) of the DTA with Argentina states that “real property” . . . includes: (a) a lease of land and any other interest in or over land, whether improved or not, including a right to explore for mineral, oil or gas deposits or other natural resources, and a right to mine those deposits or resources; and (b) a right to receive variable or fixed payments either as consideration for or in respect of the exploitation of, or the right to explore for or exploit, mineral, oil or gas deposits, quarries or other places of extraction or exploitation of natural resources.”

291 Eg, art 6(3) of the DTA with Argentina.

292 Explanatory Memorandum, International Tax Agreements Amendment Bill 1995 (Cth), 49.

293 Asprey Report, above n 10, para 17.A24 notes that Australian judicial decisions tend to focus on the elements of “form” in determining source, rather than substance. Also see Pinto (2003), above n 169, 85, Tom Magney, ‘Australia’s Double Tax Agreements: Does the OECD Model serve Australia’s Interests?’ in Richard Krever and Yuri Grbich (eds), *Australian International Tax: Recent Developments and Future Directions* (1994) ATAX Research Series, 25, 46 and Li, above n 5, 1125. Similarly, Tillinghast observes that “[t]he existing body of international tax rules . . . is based . . . on the supposition that international trade consists of the physical shipment of tangible goods or physical movement of persons to perform services at different locations” - David R Tillinghast, ‘The impact of the Internet on the taxation of international transactions’ (1996) 50 *Bulletin for International Fiscal Documentation* 524

DTAs override those domestic determinations, the next step is to explore the main thesis.

III. Evaluating the effectiveness of the law of source

The purpose of this Part is to explore whether the “rules” for determining the source of income fail, in their practical application, to satisfy the “essential objectives” of equity, efficiency, simplicity and the prevention of tax avoidance. As discussed in Chapter 2, the evaluation will be undertaken by illustrating circumstances where the law struggles to satisfy each of the evaluative criteria. The evaluative criteria are addressed in the following order: equity; efficiency; simplicity; and the prevention of tax avoidance.

However, the analysis in Part II indicates that outside the statutory source rules and DTAs the source of income is determined as “a hard matter of fact” with a weighting applied to various factors. Part III, in both Chapters 3 and 4, highlights how such fact and circumstance determinations generally fail the evaluative criteria. Therefore, to avoid duplication, the analysis will focus on the simplicity and anti-avoidance evaluative criteria. Also, as indicated previously, where some examples illustrate that a number of the evaluative criteria are not satisfied, to avoid duplication in text and analysis, it is proposed to discuss them in the context of the more relevant evaluative criteria only, with a passing reference being made to the other shortcomings.

Finally, stated above in Part II, the purpose of this Chapter is to focus on the statutory law, judicial principles that underlie a determination of the territorial source of income and how those rules are modified by DTAs. Thus, characterisation issues are outside the direct scope of the thesis as they are a preliminary classification step in the determination of source. However, as the source of income is dependent on this classification, issues have been highlighted (eg the definitions of royalty). Again, for completeness these classification issues will be briefly discussed in the context of simplicity and tax avoidance.

A. Equity

Consistent with the definition in Chapter 2, in determining compliance with the equity objective, the following discussion will highlight where the application of source results in taxpayers in similar circumstances not being taxed similarly (horizontal inequity). Vertical inequity does not arise in this context.²⁹⁴ The approach to be adopted is to examine source more broadly, before focusing on specific equity issues.

1 “Facts and circumstance” tests

As discussed above, Australian has statutory source for dividends, interest payments (where the monies are secured by mortgage on an Australian property), certain royalty payments, certain natural resource payments, business income (where business is carried on partly in and partly out of Australia, overseas shipping payments and certain insurance premiums) and exempt income in Norfolk Island. There are also origin (withholding) tax rules in respect of dividends, interest and royalties. Outside these rules the source of income is determined by ascertaining the source by weighing up the individual facts and circumstances of the taxpayer. The focus is on legal form of a transaction rather than its substance.²⁹⁵

Thus, in common with other factual tests, a finding of source could turn on a minor variation in circumstances or, hypothetically, even on a difference in a single fact. For example, by having an agent personally conclude a loan agreement in the Cook Island with a Cook Island bank, rather than transmitting the signed documentation from Australia, was crucial in determining a Cook Island source of interest income in *Spotless*.²⁹⁶

294 The Asprey Report, above n 10, para 17.65 in respect of tax on Australian origin income notes that “[m]ore refined notions of equity”, deriving from the principle of ‘ability to pay’, have no obvious relevance in the present context. Australia taxes a non-resident on a base representing only part of his total income, and does not attempt to concern itself with the remainder of his income. Ensuring that the non-resident’s tax liability reflects his ability to pay must rest with his country of residence.

295 The Asprey Report, *ibid*, paras 17.A7 and 17.A24 notes that in respect of income from sale of shares and interest has judicial decisions tend to emphasise elements of form (eg in respect of a share source is generally situated in the place where the register of the share is kept and interest is source where the contract is made).

296 *Spotless Services Ltd v Federal Commissioner of Taxation* (1993) 25 ATR 344; 93 ATC 4397.

Similarly, the different weighting applied in determining the source of income for persons earning income as employees (or even between categories of employees, eg artisans and office holders) versus those earning income from independent personal services results in horizontal inequity as persons in similar circumstances are taxed differently as income may be found to be sourced in different jurisdictions.

Given that minor variation in those circumstances can determine a particular source it is possible that the income of taxpayers in similar circumstances could have different sources. As horizontal equity is found where taxpayers in similar circumstances are taxed similarly, the individual factual nature of the determination of source under the common law means that in application they fail to deliver horizontal equity.²⁹⁷

2 Problems caused by interrelationship of DTAs

As discussed in Chapters 3 and 4, horizontal inequity also arises as DTAs only vary taxing rights for taxpayers covered by the bilateral agreement. Thus, where a taxpayer is resident in a country which does not have a DTA with Australia then that taxpayer can be taxed greater than a taxpayer who is a residence in a country with a DTA.

Even between DTAs the variation in terms from treaty to treaty means that similar income can be treated differently from DTA to DTA²⁹⁸ and the rate of country of source taxation (applying to interest, dividend, and royalty income) varies.²⁹⁹ The result of such variations is that taxpayers resident in one DTA country are subject to a higher rate of tax than one in another DTA country.

Also, the fact and circumstance nature of DTAs can give rise to inequitable results in application. For example under Australia's DTAs, Australia can only tax income from business where the non-resident has a permanent establishment (Article 7) or a presence measured by days or the existence of a fixed base (Article 14). Therefore, a one off sale

297 The existence of exemptions under the withholding tax rules, although not varying source also result in horizontal inequity as certain form of income are taxed at different rates - Asprey Report, above n 10, para 17.67.

298 Variations in DTA wording does result in different treatments of reinsurance payments – see Tim Pentony, 'Non-resident insurers: Is Division 15 of the ITAA 1936 still relevant?' (2004) 8 *Tax Specialist* 124.

299 See above Parts E 2 (d), 3 (d) and 4 (d).

of a digital product through a server owned by the non-resident will provide sufficient presence while sales of digital products into Australia through a website will not normally give rise to such presence.³⁰⁰

Finally, a possible inequity can arise from characterisation differences between domestic laws and DTAs. For example an Article may deem an amount to be interest, while it is deemed by the domestic law of the country to be a “dividend”.³⁰¹

3 Summary

From the above discussion, it is evident that the determination of source does satisfy the horizontal equity evaluative criterion (ie, taxpayers in similar circumstances are not being taxed similarly). Horizontal equity is not achieved as the:

- facts and circumstances tests can result in persons in similar circumstances having different sourced income; and
- taxpayers covered by a DTA are treated differently to taxpayers who are not covered by a DTA.

B. Efficiency (Neutrality)

In light of the discussion in Chapter 2, the efficiency (neutrality) objective is satisfied if the determination of source does not give rise to distortions such as a taxpayer being taxed differently due to the market in which the taxpayer operates (eg physical or electronic).³⁰² As with the residency rules, in determining source the same statutory tests and common law principles apply regardless of the mode of conducting business. Differences may arise in the extent to which income arising in the electronic markets is taxed to that derived in the physical markets, but that is not due to a lack of neutrality.³⁰³

300 2003 OECD Commentary on Article 5, paras 42.3-42.9.

301 See McCormack, above n 66, para 2.8.4 noted that debenture interest payments arising from floating rate debentures and debentures issued in substitution for shares in New Zealand are treated as dividends under New Zealand tax law, but are a dividend under art 10 of the New Zealand DTA, subject to a 15 per cent rather than a 10 per cent tax rate.

302 One of the key policy requirements of e-commerce taxation is the neutrality principle – see OECD Implementing the Ottawa taxation framework, above n 180, 10.

303 Cf, Lisa Cox, ‘Permanent establishments – The borderless world of electronic commerce’ (2001) 7 *New Zealand Journal of Taxation Law and Policy* 8, 9.

Rather it is a result of the fact that source of income is determined by legal jurisdictional concepts, based on physical or territorial location, and the nature of the income being determined by malleable legal characterisations of income.³⁰⁴ However, as this malleability gives rise to the opportunity for tax avoidance (see Part III D) and evasion it leads to distortions which impact adversely on neutrality.

C. Simplicity

In evaluating whether the determination of source does meet the simplicity objective, the following discussion will highlight the extent to which the determination of source, in application, does not satisfy the indicators of simplicity. In other words it will evaluate if the determination of source is predictable, proportional, consistent, clear, easy to administer, does not impose high compliance burdens and is co-ordinated with other tax rules.

As mentioned in Chapters 3 and 4, as a number of these elements overlap, a single rule may be found to satisfy a number of the individual elements of the simplicity objective. Thus, the following discussion will seek to address the problems arising under the most relevant evaluative element. The extent to which these elements exist will determine the extent to which the rules will be considered to have failed the simplicity objective in that circumstance. The evaluation will address the evaluative elements in the order set out above.

1 Predictability

The first element for judging simplicity is to determine whether the determination of source is predictable (ie it is easy to understand the intended and actual scope of the “rules”). The principal factor that influences predictability of a determination of source is that a source depends upon individual factual circumstances of the transaction.

As discussed above, at common law the “. . . ascertainment of the actual source of a given income is a practical hard matter of fact.”³⁰⁵ The outcome in any circumstance can

304 Above, n 293.

305 *Nathan v Federal Commissioner of Taxation* (1918) 25 CLR 183, 189; R & McG 14, 15.

be determined by a range of factors (such as, where a contract is made, the place of sale, location of property, the type of property, and the nature of the service provided (employment or independent)) that are weighted differently depending upon the characterisation of the income.³⁰⁶ However, even characterisation of income is not a precise exercise. The line between the classifications of income is uncertain under domestic law³⁰⁷ as it is under the various taxing rights in DTAs.³⁰⁸

Although the weighting of factors is more certain than the statutory source rules (ie the criteria are stated), the outcome is still dependent on the application of the law to a fact situation.³⁰⁹ Similarly, not only does the terminology in the various Articles vary from DTA to DTA but the outcome is still dependent on the application of the law to a fact.

On balance, as the outcome under the domestic law and the DTAs turns on the weighing of various factors, the outcome in many circumstances is difficult to predict.

2 Proportional

The second element for judging simplicity is to determine whether the complexity of the determination of source is proportional to the complexity of the policy. If the law is more complex than the policy, then the law will fail this element of the simplicity criterion. In respect of the statutory source rules generally the law is proportional to the

306 See above, Part II C 4.

307 The uncertainty exists in classifying income as arising from the sale of goods or the provision of services and as royalty income or business income - see, eg, Forgione, above n 267, 732-3, Jinyan Li, 'Rethinking Canada's source rules in the age of electronic commerce: Part 2' (1999) 47 *Canadian Tax Journal* 1411, 1421-4, Charles E McLure, 'Tax competition in a digital world' (2003) 57 *Bulletin for International Fiscal Documentation* 146, 154, Tadmor (2003), above n 135, 424, Vito Tanzi, 'Globalization, technological development, and the work of fiscal termites' (2001) 26 *Brooklyn Journal of International Law* 1261, 1266 and Aldrin De Silva, 'E-commerce' (Paper presented at the Taxation Institute of Australia's International Masterclass, 31 August 2000) 10.

308 In response to concerns about the characterisation of sales of digital information the OECD has suggested 28 categories - see OECD, *Attribution of Profits to a Permanent Establishment Involved in Electronic Commerce Transactions* (February 2001) and Arthur J Cockfield, 'The law and economics of digital taxation: Challenges to traditional tax laws and principles' (2002) 56 *Bulletin for International Fiscal Documentation* 606, 613. Also see Andrew Halkyard and Steven Sieker, 'E-commerce_tax@HongKong: Part II' (2003) 30(12) *Tax Planning International Review* 16, 20.

309 As discussed above, there are statutory source rules for dividends, interest payments (where the monies are secured by mortgage on an Australian property), certain royalties payments, certain natural resource payments, business income (where business carried partly in and partly out of Australia, overseas shipping payments and certain insurance premiums) and exempt income in Norfolk Island.

policy (ie preserve Australian source in respect of shipping, insurance and income from business conducted partially within Australia). However, it is not possible to evaluate the determination of source in terms of proportionality as source under the common law is a matter of fact unrelated to tax policy.

3 *Compliance burdens*

The third element used for judging simplicity of the determination of source is to determine qualitatively the level of cost (the burden) imposed upon a taxpayer in complying with the law. If analysis indicates that the compliance costs are high, the rules fail this element of the simplicity criterion.

In a self assessment environment a taxpayer is required to determine the source of income, in light of its individual factual circumstances. However, this process is complicated as a determination of source under the common law requires a review of a long line of often apparently conflicting United Kingdom and Australian judicial decisions. Thus, it is broadly recognised that the lack of a common rule to determine source has created uncertainty, leading to unnecessary litigation³¹⁰ and cost.³¹¹

On the other hand, the origin (withholding) taxes in respect of interest, dividends and royalties have low compliance costs as tax is imposed on a gross amount and there is no need for further assessment.³¹² Similarly, the statutory business income source rules (shipping, insurance and where business is carried on partly in and partly out of Australia) are easier to comply with as the criteria for determining “source” are explicit. However, the application of each provision still is determined by the individual circumstances of the taxpayer. Further, the statutory shipping rules, being in essence an origin test (ie five percent of the amount paid is assessable), do not fall neatly within either the current assessment or standard withholding regimes. This individual processing can create additional compliance costs.

310 Taxation Investigation Committee, New South Wales, *Report* (1937), 44.

311 See, eg, ATO’s second Internet Report, above n 7, 89 and Daniel KC Cheung and Percy Wong, ‘Hong Kong and the territorial source of business profits’ (2002) 29(12) *Tax planning International Review* 3, 11.

312 Asprey Report, above n 10, para 17.68.

Finally, as the Australian DTAs do not strictly follow the OECD Model Convention and the individual articles vary in substance and terminology from DTA to DTA (eg the treatment of government pension under the Pension Article),³¹³ each Article in each treaty has to be examined individually. This individual examination combined with application based upon individual facts adds to compliance costs.

In summary, this evaluative criterion is also not satisfied as the need to determine source by a taxpayer's facts and circumstances is a major contributor to high compliance costs.

4 Difficulty in administration

The fourth element for judging simplicity is to determine whether there are any administrative difficulties in the determination of source. If the rules are difficult to administer then the rules will fail this element of the simplicity criterion. Difficulty in administration will sometimes mirror compliance costs.

As discussed in Chapters 3 and 4, there are administrative difficulties arising from the fact and circumstance basis of the determination of source, both under the domestic law and in applying the DTAs. As a determination of source depends upon a taxpayer's circumstances, the ATO is required to make individual, subjective determinations. This uncertainty and the case by case nature of application mean that the ATO is unable to give simple broad pronouncements on how the law operates (as evidenced by the absence of public rulings on source and the issuing of specific rulings on individual DTAs).

As the self assessment system is dependent on taxpayers having the necessary information to determine their tax position, the inability to provide that information impacts adversely on the ability to self assess and the extent to which the ATO can treat as reliable, self-assessed determinations of source.³¹⁴ If reliability is low, risk is high and the ATO under its compliance model is required to devote additional resources to areas of risk.³¹⁵

313 Above, n 68.

314 This was also discussed in Chapter 4 in Part III C 4 and Part VII C 4.

315 Australian Taxation Office, Commonwealth, *Compliance Plan 2004-05* (2004).

Further, the statutory shipping rules do not fall neatly within either the assessment or the withholding regimes, which does create variations to processing systems resulting in additional administrative costs.

In summary, this evaluative criterion is also not satisfied, as the need to determine source by a taxpayer's facts and circumstances is a major contributor to tax administration difficulties for the Commissioner.

5 Co-ordinated with other tax rules

The fifth element for judging simplicity is whether the determination of source is co-ordinated with other tax rules. If the law operates independently of other tax rules, the rules will fail this element of simplicity.

As with the company residency rules (see Chapter 4 Part III C 5), the main area of divergence from other tax rules are the variations in the terminology adopted in Australian DTAs from that adopted in the OECD model articles. For example, under the Employment Article in most Australian DTAs the taxing rights in respect of the employment income are allocated to the country where the operator or the ship or airline is "resident", not the "place of effective management" (as specified in the OECD Model). Although some differences may have arisen due to the preferences of negotiating countries, the adoption of such variations also tend to slow the DTA negotiation/renegotiation process. As a result such arbitrary departures tend to counter the simplicity objective.

In summary, the DTA rules diverge from the terms adopted in the OECD model. This divergence is a further erosion of simplicity.

6 Clarity

The final element for judging simplicity is to determine whether law is expressed clearly. If the law is expressed unclearly, the law will fail this element of simplicity.

The lack of statutory source rules and limitation on the precedence of common law results in uncertainty in the determination of source. The determination of geographical location of income creation by relying on physical presence of property, persons or assets, combined with the legal principles applied to income characterisation underlie this uncertainty.³¹⁶ The impact of the growth in services combined with changes in communication technology (including the Internet) removes the need for physical presence³¹⁷ and blurs income characterisation.³¹⁸

For example, given that with the sale of goods the place of contract is often crucial, it is extremely difficult to determine the place of offer or the place of acceptance in circumstances where there is a foreign currency dealer trading, employed by an Australian company (but resident in Hong Kong) carrying out multiple trades on screen.³¹⁹ Even if elements of each contract can be isolated, the fact that the place of contract and the place of loan advance can be manipulated can create further uncertainty.³²⁰

The weighing of factors under the common law gives rise to uncertainty since no one fact is compelling. Clarity is further impeded by the variation in terminology between Australian DTAs and from the OECD model. Although the 2003 OECD Commentary seeks to provide clarity, the difficulties remain in respect of characterisation and interpretative issues.³²¹

Thus, the process for determining source is not clearly expressed, further reducing simplicity.

316 See ATO's second Internet Report, above n 7, 92.

317 See Li (1999a), above n 5, 1125 and Dale Pinto, 'Tax Issues in a world of electronic commerce' (1999) (Paper Presented at the 11th Australasian Tax Teachers Association Conference, Canberra, 6 February 2003), 14.

318 See Neil Warren, 'Tax and the Internet: An international perspective' (Paper presented at Australian Taxation Office 'Tax and the Internet' conference, Melbourne, 11 November 1997), 15 OECD commentary on art 5, OECD 26 November 2003 Public discussion draft, above n 177, 7 and Stefan Bernutz and Christina Weinreich, 'Germany: Server constitutes a permanent establishment' (2002) 4(4) *Tax planning International E-commerce* 3.

319 Tom Magney, 'Commentary: Our antiquated rules of source have been left behind by the electronic communications revolution' (1995) 3 *Taxation in Australia Red* 175.

320 As illustrated in the facts in *Spotless Services v Federal Commissioner of Taxation* (1993) 25 ATR 344; 93 ATC 4397. Also see ATO's second Internet Report, above n 7, 82-9.

321 Eg, see, DA Albregtse, 'The server as a permanent establishment and the revised commentary on Article 5 of the OECD Model Tax Treaty: Are the e-commerce corporate tax problems solved?' (2002) 30 *Intertax* 356.

From the discussion above, the determination of source fails the elements that gauge simplicity. Specifically, as the outcome at common law turns on a weighing of facts the outcome in many circumstances is not predictable. The complexity arising from the facts and circumstances approach is a major contributor to compliance costs for affected taxpayers and remains a major contributor to tax administration difficulties for the Commissioner. Further, the terminology used in the income allocation Articles in Australia's DTAs diverge from terms adopted in the OECD model affecting consistency. Overall there is a general lack of clarity.

In conclusion, the law and process for determining the source of income fails the elements that gauge simplicity (ie they are not predictable, are associated with the imposition of high compliance burdens, are difficult to administer, are not co-ordinated with other tax rules and are expressed unclearly).

D. Tax Avoidance

In determining compliance with the prevention of tax avoidance objective, the following discussion will identify the circumstances where in the application of the law there appear to be evasion or avoidance opportunities.

Generally the statutory business income source rules are not open to manipulation. In fact the statutory rule relating to business carried on partly in and partly out of Australia in fact reduces the scope for contract manipulation.³²² However, there are concerns in respect of the CGT rules that techniques have been developed to avoid the application of the capital gains tax on assets connected with Australia.³²³ However, these concerns do not relate to source.

322 Richard Vann and Ross Parsons, 'The foreign tax credit and reform of international taxation' (1986) 3 *Australian Tax Forum* 131, 152.

323 Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper* (2002), 39. The technique is simply to avoid realisation of the asset by disposing on an interposed entity (which controls the entity owning the asset connected with Australia) rather than the asset.

More generally, under the common law the same factors that impede simplicity (the reliance on legal jurisdictional concepts based on physical or territorial location) enable manipulation of the characterisation of the income³²⁴ or the manipulation source.³²⁵ Therefore, as physical presence is diminished, the scope for avoidance increases as both domestic rules and DTAs rely on presence in a particular territorial location.³²⁶

The communication revolution (including Internet) has enabled both services and the delivery of digital product to be undertaken without persons actually being physically present in the country.³²⁷ Services, such as legal, accounting, engineering and even medical services, can be delivered remotely removing physical presence.³²⁸ Services associated with high value equipment can also escape presence:

- through mobility (such as off-shore hydro-carbon industry equipment);
- by requiring little physical supervision (eg telecommunication equipment); or
- by being beyond the jurisdictional claim (satellites).³²⁹

The ability to tax such service income is diminished by the shifting of revenue out of the territory where income from the services is currently being taxed. This mobility may also provide tax arbitrage opportunities.³³⁰

However, avoidance problems associated with a reliance on legal form to determine source is an issue which predates the Internet. As discussed in Part III C 6, the facts in the *Spotless Services* case illustrate how the reliance on legal factors, such as the place

324 Basic rules for characterising source of income are being undermined by readily manipulated distinctions between categories of income (eg, the distinction between sales/licences interest and rents) - see Michael J Graetz, 'Taxing international income: Inadequate principles, outdated concepts, and unsatisfactory policies' (2001) 26 *Brooklyn Journal of International Law* 1357, 1418 and Cockfield, above n 308, 612-15.

325 See Magney (1997), above n 26, 17.

326 As discussed above, the "employment", "independent service" and "business profits" Articles in most Australian DTAs, the right to tax service income relies on a degree of physical presence (either in terms of days or through the existence of a fixed base or permanent establishment).

327 Alan Tyree *et al*, *Computer Money Consulting Pty Ltd's INNET 97/2 Report on Electronic Commerce Banking and Finance Issues* (1997) Australian Taxation Office at URL: <http://www.ato.gov.au/content/Businesses/Downloads/cmc.rft>, Part 2 as at 31 December 2002 gives . The report has subsequently been removed from ATO site. Also see Chapter 3, above n 246 and Graetz (2001), above n 324, 1419.

328 ATO's second Internet Report, above n 7, 104.

329 Vann (1995), above n 173, 22.

330 ATO's second Internet Report, above n 7, 104-5, Cockfield, above n 308, 609, and Julian JB Hickey, 'The fiscal challenge of e-commerce' [2000] *British Tax Review* 91.

of contract, can result in avoidance.³³¹ Even earlier, in the 1930s, the Second Royal Commission on Taxation noted in respect of the source of business income that:

. . . every one of the three specified factors, ie, contract, delivery and payment, can be varied at the will of the contracting parties without any alteration in the practical effect of the transaction. The non-resident trader can, therefore, please himself whether he makes himself liable for tax or not.³³²

Although the level of avoidance is the subject of conjecture, it is clear that the existing statutory rules, common law principles and the DTAs do not satisfy the prevention of tax avoidance criterion.³³³

E. Summary of Part III

In summary, from the above it is clear that the existing approach for determining the source of income is inadequate. Overall the approach for determining source fails in identified ways to satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criterion. The major weakness is the factual element of the determinations, which in certain situations:

- results in horizontal inequity;
- gives rise the lack of simplicity; and
- leaves the rules open to manipulation.

331 (1993) 25 ATR 344; 93 ATC 4397. Also see ATO's second Internet Report, above n 7, 82-9.

332 See Commonwealth, Royal Commission on Taxation, *Reports* (1933-34), 72. Similarly, the Australian Taxation Office, Commonwealth, *Tax and the Internet: Discussion Report* (1997) (ATO's first Internet Report), 47 notes that the reliance on legal jurisdictional concepts based on physical or territorial location would result in misallocation as digital product and services do not need physical presence.

333 See, eg, Gary Sprague and Rachel Hersey, 'Permanent establishments and internet-enabled enterprises: The physical presence and contract concluding dependent agent tests' (2003) 38 *Georgia Law Review* 299, 315-17 argue that fears are overrated as remote vendors of consumer goods are not the predominant model in the economy, where there is no presence vendors to not achieve same levels of success and the tax arbitrage stimulates outsourcing to developing countries. Also Reuven S Avi-Yonah, 'Tax competition and e-commerce' (2001) 23 *Tax Notes International* 1395, re multinational enterprises.

Therefore, reform is necessary to ensure that the determination of the source of income better meets the evaluative criteria. The potential reform options are the focus of following discussion in Parts IV and V.

IV. Exploring the sub-thesis - Models for reforming source

A. Overview

Given the problems identified, reform is needed.³³⁴ The common global solutions³³⁵ discussed include:

- the development of a virtual permanent establishment concept;³³⁶
- an e-commerce bit tax;³³⁷
- formulary apportionment;³³⁸ and
- an erosion (refundable withholding) tax.³³⁹

334 See Tillinghast, above n 293, 526 and Jefferson VanderWolk, 'Direct taxation in the Internet age: A fundamentalist approach' (2000) 54 *Bulletin for International Fiscal Documentation* 173.

335 In the transfer pricing context Vann has proposed an international tax institution – see Richard J Vann, 'A model tax treaty for the Asian Pacific region? (Part 1)' (1991) 45 *Bulletin for International Fiscal Documentation* 99 and Richard J Vann, 'A model tax treaty for the Asian Pacific region? (Part II)' (1991) 45 *Bulletin for International Fiscal Documentation* 151. This has been further explored as a "virtual" international organisation – see Pinto (1999), above n 317, 22-5, Prafula Fernandez and Lynne Oats, 'Creation of a cyber-entity' (1999) (Paper Presented at the 11th Australasian Tax Teachers Association Conference, Canberra, 6 February 2003), and Prafula Fernandez, Gitte Heij and Jeff Pope, 'Tax policy and electronic commerce' (2002) 56 *Bulletin for International Fiscal Documentation* 30, 35-6.

336 A virtual or impermanent establishment arises where gross sales into a jurisdiction exceed a specified amount – Sprague, above n 333, 307 and Pinto (2003) above n 169, 191-206.

337 This proposal arose from a 1994 paper by Arthur Cordell and Thomas Ran Ide (see Paul Mc Nab, 'International Reaction to electronic commerce developments' (1998) 27 *Australian Tax Review* 219, 225) and is an excise on bits transmitted over the internet (Sprague (2003), *ibid*).

338 A method for allocating the profits of a permanent establishment between countries of source and residence – see Forgione, above n 267, 767-8, Li (1999b), above n 308, 1469-72, Michael J Graetz, *Foundations of International Income Taxation* (2003), 67-75, Charles E McLure, 'Globalization, tax rules and national sovereignty' (2001) 55 *Bulletin for International Fiscal Documentation* 328, 337, Charles Plambeck, 'The taxation Implications of global trading' (1990) 48 *Tax Notes* 1143, 1155-1156, and Kerrie Sadiq, *Interjurisdictional Allocation of Multinational Banking Income: Aligning Taxation Principles with Economic Activity* (Phd Thesis, Deakin University School of Law, 2003).

339 Proposed by Doernberg, the system works on the payer deducting tax from a payment to a non-resident – see Richard Doernberg, 'Electronic commerce and international tax sharing' (1998) 16 *Tax Notes International* 1013, 1013-17, Richard Doernberg and Luc Hinneken, *Electronic Commerce and International Taxation* (1999), 315-22 and Pinto (2003), above n 169, 173-90 and 207-32. Erosion taxation is intended to supplement, not replace traditional permanent establishment nexus – Sprague (2003), above n 333, 308. In India, *Report of the High-Powered Committee on Electronic Commerce and Taxation*, (2001) the Committee recommended that erosion taxes are a

As mentioned in Chapter 1, at a domestic level a series of reforms have also been recommended by various Inquiries.³⁴⁰

However, despite the merits of these proposals the sub-thesis is that the domestic law can be modified within the jurisdictional framework to more closely meet the evaluative criteria (ie alternative approaches to the current rules that may better satisfy the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance). In order to establish the sub-thesis, as in Chapters 3 and 4, a two-step approach will be adopted. First, in this Part a review of the domestic law of source in other jurisdictions will be undertaken. The exploration of the sub-thesis, in light of these changes will be undertaken in Part V.

In light of the fact that, “. . . the concept of source is poorly developed . . . in domestic tax legislation” worldwide, with most countries having “only sketchy rules for determining the source of income,”³⁴¹ viable alternatives to Australia’s approach for determining source will not be highlighted by carrying out a comparative study with countries with poorly developed source rules. As Australia’s and Canada’s approaches to determining source at common law originates from the United Kingdom, an exploration of the rules operative in the United Kingdom and Canada is unlikely to offer dramatically different reform models and the analysis is likely to mirror the examination already undertaken in Part III in respect of the Australian law.³⁴² Therefore, the focus of

substitute to the permanent establishment concept – Daksha Baxi, ‘Indian Committee’s E-com tax recommendations’ (2002) 4(2) *Tax Planning International: E-commerce* 8.

340 See Chapter 1 Part II A. The recommendation were contained in Asprey Report, above n 10, Chapter 17A and *A Tax System Redesigned*, above n 194, Chapters 21-23. For a contrary view on the adoption of statutory source rules – see Richard Shaddick, ‘Australian tax reform: International issues’ (Paper presented at a Corporate Tax Association Discussion Group, Melbourne, 2 August 2000) 10 and Elizabeth Tromans, *Are Australia’s Common Law Source Rules for Income Sufficient to Meet Challenges of E-commerce?* (JD paper, University of Melbourne Faculty of Law, 2000), 24. Tromans argues that uncertainty does not justify statutory source rules. It is common to live with uncertainty (eg the meaning of “income”) and much complexity can be attributed to the increasingly complex way business is transacted.

341 See Brian Arnold and Michael McIntyre, *International Tax Primer* (1995), 25.

342 For an introduction to United Kingdom’s rules see Gary Richards, ‘United Kingdom’ in *Cahiers de Droit Fiscal International: Taxation of Income Derived from Electronic Commerce*, Vol LXXXVIa (2001), 711; and for Canada’s rules see Robert Couzin and Mark Novak, ‘Business Operations in Canada’ *Tax Management Foreign Income Portfolios 995TM* (3rd, 2003), A 28-31, Li (1999a), above n 5, Li (1999b), above n 308 and Nathan Boidman, ‘E-commerce taxation in Canada: The long shadow of the decision in Saint John Shipbuilding’ (2003) 57 *Bulletin for International Fiscal Documentation* 249.

the comparative study will be on two countries that have adopted statutory source rule regimes: the United States and New Zealand.³⁴³

B. New Zealand

1 Overview

New Zealand adopted an extensive statutory source regime in 1916.³⁴⁴ The current rules are principally contained in s OE 4 of the *Income Tax Act 1994* (NZ).³⁴⁵ The classes of income covered by the source rules are extensive. However, they are not exhaustive³⁴⁶ with resort to the common law necessary if the income in question is not expressly caught by the rules.³⁴⁷ Given the scope of these rules, the determination of source under the common law rules can only have a minor role. The scope rules will be briefly examined under three headings (income from personal exertion, income from business, and income from property), before evaluating the effectiveness of the rules.³⁴⁸

2 Income from personal services

All salary, wages, allowances and emoluments of any kind earned in New Zealand in the service of either a resident or non-resident are deemed to have a New Zealand source.³⁴⁹ Also deemed to have a New Zealand source are any Government pensions or annuities, specific superannuation payments or any ex gratia payment which is a pension.³⁵⁰

343 Evaluation of each country's DTA models will not be undertaken as the criticisms expressed in Part III in respect of Australian DTAs will equally apply to United States and New Zealand DTAs. DTAs in these countries also depart from the OECD model and there are textual variations between DTAs (as they are also negotiated individually). Further, the United States DTAs are not a good practice model as the DTA source rules does not always override the United States domestic source rules (ie there is treaty override) – see Michael McIntyre, *The International Income Tax Rules of the United States* (2nd ed, 1992) 3-3.

344 Introduced by the *Income Tax Act 1916* (NZ) – see Garth A Harris, *New Zealand's International Taxation* (1990), 3.

345 Other source rules are in *Income Tax Act 1994* (NZ) ss OE 5 and OE 6 and apportionment rule (similar to the Australian rules in ss 38-43 of the 1936 Act) in s FB2.

346 Garth Harris, above n 344, 3.

347 *Income Tax Act 1994* (NZ) s OE 4(1)(u).

348 There are some miscellaneous source rules that do not fit neatly under these classifications. They include payments of compensation or allowances (as defined in *Tax Act 1994* (NZ) ss CC 1(1)(a) and (b)), income derived from money invested by the Public Trust Office or the Maori Trust Office and New Zealand derived income derived by a beneficiary under any trust - see *Income Tax Act 1994* (NZ) s OE 4(1)(d), (k) and (p) (respectively).

349 *Income Tax Act 1994* (NZ) s OE 4(1)(c).

350 *Income Tax Act 1994* (NZ) s OE 4(1)(h) and (j).

Where a contract for employment or independent services is made wholly or partially in New Zealand, that income also has a New Zealand source.³⁵¹ However, if the service is under a contract entered into outside New Zealand the source of income is determined in accordance with the common law (see discussion in Part II C 3(a)).³⁵²

As in Australia, these source rules are modified by the treaty provisions relating to employment, independent services, directors, entertainers, sportspersons, students, teachers, academics, pensions, alimony, employee benefits and diplomats.³⁵³

3 *Income from business*

In common with Australia, New Zealand has statutory source rules related to shipping³⁵⁴ and insurance income³⁵⁵ and an income allocation rule where either a business is carried on partly in and partly out of New Zealand or there is whole or partial performance of a contract.³⁵⁶ More generally, income derived from any business wholly or partly carried on in New Zealand will have a New Zealand source, including its interest, dividend and royalty.³⁵⁷ The meaning of business and the determination of where it is being carried on

351 Under *Income Tax Act 1994* (NZ) s OE 4(1)(q) – see Garth Harris, above n 344, 26. This was illustrated in *Ayson v Commissioner of Tax* [1938] NZLR 282 where salaries three public servants, stationed in the Cook Islands and paid from the Cook Island Treasury, were deemed to have a New Zealand source as the contracts were made in New Zealand. As the source of payment was New Zealand Parliament, no apportionment was allowed. The *Income Tax Act 1994* (NZ) s FB2 permits apportionment.

352 Mark Keating, above n 62, 4. Regardless of source New Zealand does operates non-resident contractors withholding tax regime (NRCWT) which withhold either 15 or 30 percent of payments made to non-resident contractors in respect of services in New Zealand or the right to use property.

353 See, eg art 19 of the New Zealand DTA deals with pension, annuities, alimony and other maintenance payments. However, unlike pensions, which are assessed on the basis of residency, alimony and other maintenance payments are taxable in country of source. For a further analysis of the DTA with Australia see Michael Dirks, "Australia: Australia-New Zealand Tax Treaty" (1995) 49 *Bulletin for International Fiscal Documentation* 583.

354 *Income Tax Act 1994* (NZ) s OE 4(1)(t). It deems income derived from the carriage by sea or by air of merchandise, goods, livestock, mails, or passengers shipped or embarked in New Zealand to have a New Zealand source.

355 *Income Tax Act 1994* (NZ) s OE 4(1)(o). It applies any premium derived from or in respect of any contract of insurance, offered or entered into in New Zealand or where the insured person is resident in New Zealand. It applies to premiums where the insured person is resident outside New Zealand and the contract is entered into for the purposes of a business carried on by the person in New Zealand through a fixed establishment in New Zealand, but will not apply if all the risk is located outside New Zealand and the insurer is not associated with the insured person.

356 *Income Tax Act 1994* (NZ) s FB 2(1).

357 *Income Tax Act 1994* (NZ) ss OE 4(1)(a) and (b).

will depend upon the individual facts and is determined according to common law principles.³⁵⁸

Business income arising from contracts made or wholly or partly performed in New Zealand also have a New Zealand source³⁵⁹ as do commission agency contracts performed out of New Zealand.³⁶⁰ Although New Zealand does not have a capital gains tax, a New Zealand source is applied to any income derived from the sale or other disposition of any property, corporeal or incorporeal, situated in New Zealand.³⁶¹ Again these rules are modified by New Zealand DTAs.³⁶²

4 *Income from property*

A New Zealand source arises in respect of interest on monies lent in New Zealand,³⁶³ in respect of mortgaged land,³⁶⁴ debentures or securities issued by Government, local authorities or a New Zealand resident company³⁶⁵ and in limited circumstances to interest lent outside New Zealand to a New Zealand resident or a non-resident who uses the money in a New Zealand permanent establishment.³⁶⁶

Dividends derived from a company resident in New Zealand³⁶⁷ have a New Zealand source, as does rental income.³⁶⁸ Royalties and payments for the use of or the right to use any personal property in New Zealand paid to New Zealand residents or paid to non-

358 See Jan James, Neil A Russ and Marie Pallot, 'New Zealand' in *Cahiers*, Vol LXXXVIa, above n 342, 579, 583-7.

359 *Income Tax Act 1994* (NZ) s OE 4(1)(q).

360 *Income Tax Act 1994* (NZ) s OE 5.

361 *Income Tax Act 1994* (NZ) s OE 4(1)(l).

362 The source rules are modified by the business income, shipping and independent service articles. New Zealand, like Australia, does not fully adopt the OECD Model Convention and has reservation in respect of insurance (2003 OECD Commentary on Article 7, para 41) and shipping (2003 OECD Commentary on Article 8, para 31) income. Also, in respect dividends, interest and royalties paid to non-residents New Zealand does operate a non-resident withholding tax (NRWT) regime.

363 *Income Tax Act 1994* (NZ) s OE4(1)(m), but is subject to the application provisions of s CZ 2.

364 *Income Tax Act 1994* (NZ) s OE4(1)(f).

365 *Income Tax Act 1994* (NZ) s OE4(1)(g) and (h).

366 *Income Tax Act 1994* (NZ) s OE4(1)(n) but is subject to the application provisions of s CZ 2.

367 *Income Tax Act 1994* (NZ) ss OE4(1)(g) and s OE 6 deems a foreign source for certain dividends paid by non-resident companies purposes of DTAs.

368 *Income Tax Act 1994* (NZ) s OE4(1)(e). This source rules also applies fines and premiums, which are income under s CE 1(1)(e).

residents out of New Zealand income have a New Zealand source.³⁶⁹ Again, these rules are modified by New Zealand DTAs.³⁷⁰

5 Evaluating the New Zealand source rules

In briefly evaluating the New Zealand rules against the evaluative criteria, the focus will be on whether the New Zealand source rules appear broadly to better satisfy the simplicity and tax avoidance criteria.

Spelling out a series of defined tests against which the source of income can be determined assists in predicting outcomes and enhances clarity. It thereby, arguably, reduces compliance and administrative costs. In particular, specifying that all salary, wages, allowances and emoluments of any kind earned from service in New Zealand have a New Zealand source overcomes the uncertainty in Australia arising from *Mitchum's* case.³⁷¹ Similarly, by specifying the complete list of source rules, and the requirements of each, certainty is improved dramatically.

However, despite these improvements a determination of source still turns on the existence individual facts and circumstances that satisfy the conditions of the test (eg, under the business source rule there must be a “business” and the “business must be carried on”).³⁷² Further, as discussed above, where a transaction falls outside the specific rules source is then determined by a factual determination at common law. This continued reliance on facts and circumstances (be it more diminished) does potentially give rise to horizontal inequity (as taxpayers in similar circumstances are treated differently) and fails the simplicity requirement (by reducing predictability and certainty, possibly giving rise the compliance costs and administrative difficulties).

369 *Income Tax Act 1994* (NZ) s OE4(1)(r) and (s), respectively.

370 The source rules are modified by the dividend, interest, royalty and real property articles.

371 *Federal Commissioner of Taxation v Mitchum* (1965) 113 CLR 401; 13 ATD 497; 9 AITR 559, which found that the place the place of service was not always the determinative factor in determining source of personal service income.

372 *Income Tax Act 1994* (NZ) s OE 4(1)(a).

The statutory rules do counter aspects of avoidance. For example, the rules stop some contractual manipulation, such as in *Spotless*,³⁷³ as the source of income under a contract is where any element of the contract is carried out.³⁷⁴ Thus, the contract rule could encompass internet transactions (even an isolated sale) where acceptance or offer occurs in New Zealand.³⁷⁵ However, the provision of services by the Internet, where a contract is conducted entirely offshore and payment is offshore may be more difficult to capture under the business rule. In these circumstances it would be hard to establish that part of a business is being carried on in New Zealand.³⁷⁶ Thus, although a source rule based upon the existence of elements of a contract can reduce avoidance, this reliance on legal form still enables avoidance. All taxpayers need to do is to ensure that all elements of a contract occur outside New Zealand.

On balance, although the New Zealand source rules in some limited circumstances depend upon determinations of source at common law (based upon facts and circumstances) they do still better meet the evaluative criteria of simplicity and the prevention of tax avoidance than the Australian approach. A major weakness is that New Zealand still relies on legal concepts (such as the elements of a contract) to determine source, despite such rules being subject to manipulation.

C. United States

1 Overview

Under the United States tax system the source rules serve a number of purposes.³⁷⁷ The primary purposes are to enable residents to obtain foreign tax credits where taxes are paid in respect of income with a foreign source and to determine which income of non-

373 In *Spotless Services Ltd v FCT* (1993) 25 ATR 344; 93 ATC 4397, the source interest was the Cook Islands where only the final act of accepting the offer was performed. All the early negotiation was conducted in Australia.

374 *Income Tax Act 1994* (NZ) s OE4 (1)(q).

375 James, above n 358, 582. Internet transactions are potentially caught under four rules: contracts wholly and partially in New Zealand; income from business, wholly or partially in New Zealand; other income; and royalty.

376 James, *ibid*, 587. However, the Inland Revenue disagrees in its publication 'Guidelines to taxation and the Internet' (2001) – cited in James, *ibid*.

377 *Internal Revenue Code of 1986*, IRC Reg § 1.861-8(f) lists the operative provisions requiring source determinations – see McIntyre, above n 343, 3-1b.

residents is taxable in the United States.³⁷⁸ Like New Zealand, the statutory source rules in the United States have longevity, being introduced in 1921.³⁷⁹ Unlike New Zealand the United States source rules apply to deductions, usually mirroring the income source rules. Although the 1921 frame work and language has survived, there has been significant modification with the provisions.³⁸⁰ Given the extensive nature of the rules, the following examination will focus on examining the principal rules under three headings (income from personal exertion, income from business, and income from property), before evaluating the effectiveness of the rules.³⁸¹

2 *Income from personal services*

The gross income from labor or personal services performed in the United States will generally have a United States source.³⁸² However, the income will not have a United States source where the services are preformed by a nonresident alien individual and the individual:

- is employed by a foreign employer (not engaged in trade or business within the United States),³⁸³ is a United States citizen (if services are performed off-shore), or is a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country;
- is temporarily present in the United States for a period or periods not exceeding a total of 90 days; and
- earns less than \$3,000.³⁸⁴

378 Klaus Vogel, 'Worldwide vs source of income - A review and revaluation of arguments (Part I)' (1988) 9 *Intertax* 216, 223. The distinction between non-resident income effectively connected with trade and non-resident income taxed on a gross basis is also seen as important – see Hermann B Bouma, 'The US Tax Code and reality: Improving the connection' (1999) 19 *Tax Notes International* 1647, 1651.

379 *An Act To Reduce and Equalize Taxation, to Provide Revenue, and for Other Purposes*, Public Law No 98, 42 Stat 224, s 217 (1921) cited in Vogel, *ibid*. It followed the adoption of the concept of "source" in the United States' tax law in 1916.

380 Joseph Isenbergh, *International Taxation* (2003) (electronic), P10.2.

381 For a more exhaustive review – see Graetz (2003), above n 338, Ch 2, Joseph Isenbergh, *International Taxation* (2000), Ch 3, and McIntyre, above n 343, Ch 3.

382 *Internal Revenue Code of 1986*, IRC § 861(a)(3).

383 *Internal Revenue Code of 1986*, IRC § 864(b)(1) includes personal service performed in the United States, but not in these circumstances.

384 *Internal Revenue Code of 1986*, IRC § 861(a)(3)(A),(B), and (C). As the \$3,000 threshold was introduced in 1954 it has become a meaningless threshold – see Richard L Doernberg, *International Taxation in a Nutshell* (5th ed, 2001), 72. There is also a commercial traveler's exemption - *Internal Revenue Code of 1986*, IRC § 864(b)(1) and Reg § 1.861-4(a) (3).

Where the gross income is derived from services performed in more than one country it is apportioned, usually on the basis of number of days.³⁸⁵ The income (compensation) includes fringe benefits, pension payments, sales commissions and even advertising income.³⁸⁶ However, the Internal Revenue Code does not define “labor or personal service”, which can lead to income characterisation problems.³⁸⁷ Further, there are no explicit source rules for alimony and unemployment compensation.³⁸⁸

3 *Income from business*

There is not a single source rule for income from business. The gross income from the purchase and sale of inventory³⁸⁹ is at the place the sale takes place,³⁹⁰ while sales of personal property (inventory, personal depreciable property, intangibles and goodwill) through an office or fixed place of business, in the United States, will also have a United States source.³⁹¹ Similarly, amounts received as underwriting income derived from the issuing (or reinsuring) of any insurance or annuity contract³⁹² (including reinsurance) in respect of risk in the United States will have a United States source³⁹³ as will income from certain railroad rolling stock.³⁹⁴

Gains, profits, and income from the disposal of a United States real property interest³⁹⁵ is treated as income from sources within the United States.³⁹⁶

4 *Income from property*

A United States source is applied to gross interest on bonds, notes, or other interest bearing obligations of non-corporate residents or domestic corporations³⁹⁷ and to gross

385 *Internal Revenue Code of 1986*, IRC § 863(b)(1) and Reg § 1.861-4(b).

386 Doernberg, above n 384, 72. Social security benefits (as defined in § 86(d)) are expressly deemed to have a United States source - *Internal Revenue Code of 1986*, IRC § 861(a)(8).

387 McIntyre, above n 343, 3-29a.

388 Isenbergh (2003), above n 380, P10.4.

389 As defined in *Internal Revenue Code of 1986*, IRC § 865(i)(1).

390 *Internal Revenue Code of 1986*, IRC §§ 861(a)(6) and 865(b).

391 *Internal Revenue Code of 1986*, IRC § 865(e).

392 As defined in *Internal Revenue Code of 1986*, IRC § 832(b)(3).

393 *Internal Revenue Code of 1986*, IRC §§ 861(a)(7).

394 *Internal Revenue Code of 1986*, IRC §§ 861(e).

395 As defined in *Internal Revenue Code of 1986*, IRC § 897(c).

396 *Internal Revenue Code of 1986*, IRC §§ 861(a)(5).

amounts received as dividends from a domestic corporation and from most foreign corporations.³⁹⁸ Rental income from property (including any interest in property) located in the United States and royalties for the use of United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property will also have a United States source.³⁹⁹

5 Evaluating the United States source rules

In briefly evaluating the United States rules against the evaluative criteria, the focus, as with the New Zealand evaluation, will be on whether the United States source rules appear broadly to better satisfy the simplicity and tax avoidance criteria.

Again, spelling out a series of defined tests against which source can be judged *prima facie* assists in predicting outcomes and enhances clarity. Although the United States source rules initially appear clear, they are elaborate (complex) and accommodate a number of purposes (in particular the source rules not only deal with non-residents but domestic source rules for residents).⁴⁰⁰ This complexity gives rise to uncertainty and cause additional compliance costs through dispute and litigation.⁴⁰¹ The uncertainty associated with characterisation of some categories of income⁴⁰² has been further compounded by developments in e-commerce.⁴⁰³ Further, despite the complexity the rules are not comprehensive with some categories of income not covered.

397 *Internal Revenue Code of 1986*, IRC §§ 861(a)(1). However, it will not include interest of a resident alien individual or domestic corporation that meets the 80 percent foreign business test (in *Internal Revenue Code of 1986*, IRC §§ 861(c)) or interest on deposits with a foreign branch of a domestic corporation or a domestic partnership is engaged in the commercial banking business.

398 *Internal Revenue Code of 1986*, IRC §§ 861(a)(2).

399 *Internal Revenue Code of 1986*, IRC §§ 861(a)(4).

400 Some of these purposes are contradictory – see Isenbergh (2003), above n 380, P10.3 and Graetz (2003), above n 338, 51.

401 Vogel, above n 378, 225.

402 Isenbergh (2003), above n 380, P10.5 explores the fine line between services given by (writers, artists, inventors, etc) and the transfer of their intangible property.

403 See, eg, John K Sweet, 'Formulating international tax laws in the age of electronic commerce: The possible ascendancy of residence-based taxation in an era of eroding traditional income tax principles' (1998) 146 *University of Pennsylvania Law Review* 1949 and Arthur Cockfield, 'Tax compliance issues for US companies with international electronic commerce transactions' (2000) 20 *Tax Notes International* 223, 228.

The allocation of interest rules have been problematic,⁴⁰⁴ allowing companies to manipulate the structure of loans to increase the level of tax credits by shifting the source of more of the interest off shore.⁴⁰⁵ The avoidance opportunities are increased by the ability to alter the characterisation of income through the so-called “check-the-box” regime (which provides for an interposed entity to be disregarded for United States tax purposes). Thus, what is debt in Norway may become equity in the United States.⁴⁰⁶

However, it must be noted that much of the manipulation and complexity arises from the domestic source rules, not in association with the rules applicable to non-residents.⁴⁰⁷ Therefore, on balance, the United States source rules do better meet the evaluative criteria of simplicity and the prevention of tax avoidance than the Australian approach. In being more comprehensive than New Zealand they have become more complex and in some cases facilitate tax manipulation (particularly in the context of domestic source rules).

D. Summary

The statutory source rules adopted in New Zealand and the United States present two very different models. The New Zealand model is solely focused on source rules for non-residents, while the United States’ regime focuses on domestic and non-resident source rules. Despite the width of the source regimes (in particular the United States model) neither of the source regimes covered all classes of income.

In respect of non-residents both statutory schemes do improve clarity by setting out the criteria needed to make a determination of source, but, as discussed above, the United States model is inherently complex. Further, the New Zealand model still relies on some fact and circumstance determinations under the common law, which in some cases gives rise to complexity. Thus, despite setting out the source rules in a more coherent manner, both models so not fully satisfy the simplicity criterion.

404 *Internal Revenue Code of 1986*, IRC §§ 864(e).

405 Doernberg, above n 384, 94-9 and Isenbergh (2000), above n 381, 29-33.

406 See, eg, H David Rosenbloom, ‘The David R Tillinghast Lecture: International tax arbitration and the “international tax system”’ (2000) 53 *Tax Law Review* 137.

407 McIntyre, above n 343, 3-66-7. The complex rules for non-residents are those relating to royalties (as they require a determination of use in respect of intangible property) and the sale of personal

Although some manipulation is reduced, both source regimes were still vulnerable to avoidance. In the case of New Zealand this arose from reliance of legal form, while the manipulation under the United States model arises from conflicting policies, poorly implemented.

On balance, despite these shortcomings, generally these statutory models do seem to better meet the evaluative criterion of simplicity than the current Australian regime.

V. Reform options for source

A. Overview

In Part III it was established that Australia's current law of source failed the evaluative criteria of equity, efficiency, simplicity and the prevention tax avoidance. In order to explore the sub-thesis (that the law can be modified within the jurisdictional framework to more closely meet the evaluative criteria) a review of source models adopted in other jurisdiction was conducted in Part IV, focusing on the domestic statutory source rules adopted in the United States and New Zealand. Although it was established that neither country's source rule model satisfied all the evaluative criteria, it is clear that clarity (simplicity) can be enhanced through a clear articulation of source.

Therefore, the purpose of this Part is to explore whether the modification, through codification, of Australia's current existing source "rules" can result in the law that better meets the evaluative criteria. The approach to be adopted in Part V is the same as adopted in Chapters 3 and 4. It involves changing some of the existing tests from the facts and circumstance model to specific criteria models (ie trading-off equity for simplicity and the prevention of tax avoidance).⁴⁰⁸

property in association with the office source rule (due to the passage of title test that determines place of sale).

408 This is consistent with the approach set out in Chapter 2, ie where the tax policy objectives are in conflict, the reform option that provides a balance between the equity tax policy objective and the simplicity and anti-avoidance tax policy objectives will prevail, where equity objective leads to negative outcome in terms of complexity (simplicity) and tax avoidance.

B. Reform options

In order to determine whether the current determination of source can be modified within the jurisdictional framework to better meet the evaluative criteria, the process will be to consider the various reform options under the following three headings: income from personal exertion, income from business (including the taxation of capital gains), and income from property.

1 *Income from personal exertion*

As discussed above (Part III C) there is no statutory or common law rule that determines the source of personal service income.⁴⁰⁹ However, it does appear that under the common law different weighting is applied in determining the source of income for persons earning income as employees (or even between categories of employees, eg artisans and office holders) versus those persons earning income from independent personal services. The place of service often gives weight to the determination of the source of employment income, while the place of business often gives weight to the determination of the source of income from personal services.

(a) *Evaluating options for reform*

In 1975 the Asprey Committee stated that the place of performance of service should be adopted as the test of source where the services are performed as an employee.⁴¹⁰ The Committee recognised, but did not endorse, a recommendation by the Commissioner of Taxation that place of performance should also be the test for services performed independently.⁴¹¹

Similarly, in *A Tax System Redesigned*,⁴¹² the Review of Business Taxation recommended the introduction of a general source principle which provides that personal service income is to be sourced in Australia to the extent such income derives from

409 See, eg. *Federal Commissioner of Taxation v Mitchum* (1965) 113 CLR 401, 408; 13 ATD 497, 502; 9 AITR 559, 568 (Taylor J).

410 Asprey Report, above n 10, 275.

411 Asprey Report, *ibid*.

412 *A Tax System Redesigned*, above n 194.

functions performed in Australia or risks assumed in Australia.⁴¹³ Under the proposed rules, the place where a contract is concluded is to be disregarded for source purposes. This “place of service” approach is also used under both the United States and New Zealand source rules.

If all personal service income was sourced at the place of service, then horizontal inequity will be reduced as the source of personal service income will be determined for all taxpayers under the same criteria.

The adoption of a “place of service” rule should also improve simplicity. By specifying that the place of service is the source of personal service income, the rule is clearer, the outcome is more predictable and as a result, compliance costs should reduce.

Finally, the removal of any reliance on legal form (ie the place of contract) should reduce tax avoidance. Non-resident providers of independent services would be unable to argue that as the place of contract and the place of payment are offshore, that income arising from services provided in Australia did not have an Australian source.

(b) Finding the balance

Given the strong line of cases that continue to confirm that the place of service is the dominant fact in determining the source of employment income, the adoption of such a source rule would accord with the jurisdictional claim. This change would ensure that the test more closely meets the tax policy objectives, in particular simplicity and the prevention of avoidance.

However, the adoption of such a “place of service” test for independent service income and specific categories or employees (eg artisans and office holders) would be a major variation to the jurisdictional claim, as the place of business (including place of contract) is often the factor that determines the source of income from independent personal services. As this codification narrows the range of possible sources of independent service income that could be determined from the weighting of facts under

413 Ibid, Recommendation 23.2(c).

the common law, the currently “unrestricted” jurisdictional claim is altered. Therefore, this change cannot be recommended in the context of the sub-thesis.

2 Income from business (including the taxation of capital gains)

As discussed above (Part III D) the source of business income is determined by:

- two specific statutory source rules (rules related to shipping and insurance income);
- two specific income allocation rules (rules where business is carried on partly in and partly out of Australia and specific deeming rules where a business is controlled off shore); and
- a CGT “sufficient connection” rule that prescribes the assets, owned by non-residents for which Australia retains taxing rights;

and, outside these statutory criteria, is determined under the common law. The determination of source of business income at common law consists of weighing of all the facts.⁴¹⁴

(a) Evaluating options for reform

The options for reform, if any, will be considered in the statutory rules and the common law.

(i) Business income statutory rules

The shipping and insurance rules (contained Division 12 and 15 of the 1936 Act) clearly deem an Australian source in respect of income that derives from functions performed in Australia, assets located or used in Australia, or risks assumed in Australia.⁴¹⁵ The rules are clear and the outcome is generally predictable. Thus, they are simple and are not open to blatant manipulation.

414 As noted above, the key factors in determining the source of business income include the location of economic activity, importance of contracts and the location of real property.

415 They are consistent with Recommendation 23.2(c) of A Tax System Redesigned, above n 194, 684.

The other key statutory rule (which assigns an Australian source to income derived where goods are manufactured offshore by a non-resident, or goods are purchased offshore, imported into Australia and sold) was found by the Asprey Committee to be simple and resistant to tax avoidance.⁴¹⁶ Finally, although there are concerns that non-residents can easily avoid capital gains tax by disposing of non-resident interposed entities with underlying Australian assets, this manipulation will not be resolved by source codification as it is an enforcement and collection issue arising from legal form, not related to source.

(ii) *Common law*

The determination of the source of business income at common law is far from simple and, being based upon legal jurisdictional concepts (such as the place of contract), it fails to satisfy the anti-avoidance criterion. The Asprey Committee and the Review of Business Taxation both recommended the abandonment these legal jurisdictional concepts (including the use of the place of contract as the basis for source determination).⁴¹⁷ The Asprey Committee recommended the adoption of rules that seek to identify source of income arising where it is a product of economic activity in Australia.⁴¹⁸

Similarly, the Review of Business Taxation recommended the introduction of a general source principle that provides that “income is to be sourced in Australia to the extent such income derives from functions performed in Australia, assets located or used in Australia, or risks assumed in Australia.”⁴¹⁹

416 Asprey Report, above n 10, 273. However the committee wish to limit its scope “. . . to stop profit from a casual sale having a source in Australia.”

417 Asprey Report, above n 10, 265 and A Tax System Redesigned, above n 194, 684, Recommendation 23.2(c)(ii).

418 Asprey Report, *ibid*. The Committee produced a list of possible source rules in Ch 17A.

419 A Tax System Redesigned, above n 194, Recommendation 23.2(c)(i). This approach is not new. In the 1930s the Second Royal Commission on Taxation noted in applying the principle of taxing based upon economic allegiance (obligation) that the rules need to look at “where the income is physically or economically produced” and where “the final results of the process, as a complete production of wealth,” is actually to be found – see Commonwealth, Royal Commission on Taxation, *Reports* (1933-34), 65. There is also strong academic support for source rules linked to the location of real economic activity, the location of customers, workers or assets – see, eg, Graetz (2001), above n 324, 1419.

An alternate approach is to adopt the permanent establishment test in lieu of the current determination of source of business income. Thus, an Australian source will only arise if the non-resident has sufficient presence in Australia.⁴²⁰ As the domestic source rules would be consistent with DTAs the horizontal inequity between non-residents covered by DTAs and those not would be resolved. Consistency with the DTAs would simplify the law by broadly having one set of rules. However, casual sales caught under ss 38 to 43 of the 1936 Act would no longer be within Australia's tax net.

(b) Finding the balance

While the statutory rules appear to broadly meet the evaluative criteria, providing little scope for reform, the determination of the source of business income under the common law cannot meet the evaluative criteria without significant reform. This reform requires codification of the common law principles (if possible) and modification in accordance with the suggested models, such that the new statutory rules link source to the location of real economic activity (ie the location of customers, workers or assets).

As codification narrows range of possible sources of business income that could be determined from the weighting of facts under the common law, the currently "unrestricted" jurisdictional claim is altered. Therefore, as this change would significantly vary the current jurisdictional claim, in the context of the sub-thesis the suggestions cannot be adopted. Thus, it is not possible to vary the source of business income "rules" to better meet the evaluative criteria.

3 Income from property

The determination of the source of income from property is based upon a combination of statutory tests and the common law depending upon the characterisation of the income.⁴²¹

420 See Magney (1994b), above n 293, 47-8 and Cannon (2004), above n 6, 9-11. This approach is broadly consistent with a number of the recommendations of the Asprey Committee - see Asprey Report, above n 10, 273.

Thus, where the amount is dividend or royalty income the source is determined principally under statute. The source of a dividend paid to a non-resident is determined under the 1936 Act s 44(1) to be the source of the profits from which the dividend has been paid. The process for determining “source of profits” is determined under the common law. Similarly, there are two statutory source rules applicable to royalties; a general provision and a specific rule for certain “natural resource” royalties. Broadly, under these rules a royalty will have an Australian source where it is paid or credited by a resident to a non-resident. As the statutory rules apply for limited purposes (ie they do not deal with inbound royalties and in respect of foreign tax credits), the source of royalty income is also determined under the common law.

Where the amount is interest or income from real property, the common law tends to have precedence. Although interest is deemed to have an Australian source where the monies are secured by mortgage on an Australian property, outside this narrow statutory source rule the process for determining source is set out in the common law. Similarly, the source of income from real property is determined at common law. Generally, as the real property income derives from immovable property, its source is where the underlying property is located.

(a) Evaluating options for reform

One approach to simplifying the determination of the source of property income is to codify the existing source rules such that a determined source could occur without reference to the common law. This codification would minimise avoidance through manipulation of the place of contract. By using the debit/equity rules characterisation issues and manipulation, as experienced in the United States, could be minimised.

The Asprey Committee went further suggesting that the test of origin for purposes of withholding tax should in general be adopted as the tests of source for purposes of tax by assessment.⁴²² The Committee argued that the tests would improve simplicity, being

421 The crucial factors in determining source of property income at common law are the legal jurisdictional factors (such as the location of the property) and the contract under which the rights give rise to the income.

422 Asprey Report, above n 10, 278. Also see Magney (1994b), above n 293, 48-68.

easy to administer, simple to comply with (ie determine a fixed percentage of the gross income amount) and providing certainty.⁴²³

(b) Finding the balance

Despite the advantages of removing impact of arbitrary legal jurisdictional tests (such as the place of contract), particularly in respect of interest, through the adoption of origin rules, that very removal represents a jurisdictional change.

However, it would be possible to codify the source of income from real property in Australia as having a source in Australia. As this position is reflected in the common law it would be within jurisdiction.⁴²⁴ This minor change would clarify the law resulting in some increased certainty (simplicity).

C. Summary

As source of income in Australia is generally determined by weighing facts in accordance with legal jurisdiction principles embodied in the common law, it is difficult to modify the rules within the jurisdictional framework to better meet the evaluative criteria. Only limited codification, in respect of income from employment and income from real property, can be undertaken without changes to the jurisdictional claim. Thus, despite the merits of statutory source rules, the determination of source cannot be broadly modified to better meet the essential criteria.

VI. Conclusion

A. The main thesis

The purpose of the analysis in Parts II and III of this Chapter was to establish the main thesis in respect of the determination of the source of income, that is:

423 Asprey Report, *ibid* and McIntyre, above n 343, 3-66.

424 Asprey Report, above n 10, 276.

The law, as applying in the 1997 Act, is inadequate as the law fails in its practical application to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

In Part III of the Chapter, the scope of the determination of the source of income was explored, and it was found that the existing law for determining source is inadequate. Overall the approach for determining source fails in identified ways to satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criteria. The major weakness is the factual element of the determination at common law, which in certain situations:

- results in horizontal inequity;
- gives rise the lack of simplicity; and
- leaves the rules open to manipulation.

Thus, it has been established that the determination of the source of income in the 1997 Act is inadequate as the law fails in its practical application to satisfy the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

B. The sub-thesis

The purpose of the analysis in Parts IV and V of this Chapter was to establish the sub-thesis in respect of the determination of the source of income, that is:

The domestic law can be modified within the jurisdictional framework to more closely meet the "essential objectives" of equity, efficiency, simplicity and the prevention of tax avoidance.

The comparative study in Part IV indicated that codified source rules do better meet the evaluative criteria of simplicity and prevention of tax avoidance. However, despite the merits of statutory source rules, the analysis in Part V found that there was limited scope to modify the process for determining source, within the jurisdictional framework to better meet the "essential objectives". The minor changes identified were limited to

codifying source rules in respect of income from employment and income from real property.

In summary, given the factual nature of the determination of source at common law, there is little scope to introduce statutory source rules without altering the jurisdictional frame work.

Chapter 6

Summation, revelations and the way ahead

I. Summation

This thesis has argued that the law of residency and determination of source under Australia's income tax law (the *Income Tax Assessment Act 1997* (Cth)) is inadequate in its practical application when judged against the four tax policy objectives; equity, efficiency, simplicity and the prevention of tax avoidance. It establishes that the residency rules (applicable to individuals, companies and trusts) and the determination of the source of income do not meet those objectives (particularly in respect of simplicity and the prevention of avoidance).

This finding is significant as it provides a contemporary, comprehensive evaluation of residency and source (including the impact of related rules under Australia's system of DTAs) against a robust tax policy framework. Although there have been recent Australian governmental reviews, such as the 1999 broad inquiry into Australia's business tax regime by the Review of Business Taxation¹ and the 2002 Treasury *Review of International Taxation Arrangements*,² they have not been focused on a comprehensive review of the key jurisdictional boundaries of the Australian tax system, residency and source. Further, both governmental and academic criticisms of the rules in the past have tended to be focused upon identifying isolated circumstances where the law in operation fails and then to make recommendations for reform. This analysis has not been based upon a comprehensive review of residency and source against specified objective tax policy criteria.

The thesis also highlights the lack of coherent tax policy development in respect of defining these jurisdictional taxing boundaries. Although there was governmental debate from the late 1880's until the 1930s on whether Australia should tax on a residency

1 Review of Business Taxation, Commonwealth, *A Tax System Redesigned* (1999).

2 Treasury, Commonwealth, *Review of International Taxation Arrangements: Consultation Paper* (2002) (the Consultation Paper).

basis,³ this analysis did not involve a systematic analysis of what particular transactions should be in Australia's tax net, except to generally exclude foreign source dividends and other income taxed in other jurisdictions.

The thesis also argues that there is scope to modify the law, within the jurisdictional framework, so that it more closely meets the tax policy objectives. The thesis identifies very limited areas where change, consistent with the tax policy objectives and within the jurisdictional boundaries is achievable. It concludes, after an exhaustive review and analysis of the operation of residency and source, that any significant change is not possible without reconsidering Australia's jurisdictional claim.

This finding is significant as it reinforces calls made by the ATO in 1997 in its Report on Taxation and the Internet for the current source, residency, and permanent establishment rules to be substantially revised,⁴ and the more limited reform recommendations of the two more recent governmental reviews (ie a generic recommendation for reform of the source "rules"⁵ and options for reforming elements of the company residency test⁶). It illustrates the need for a contemporary comprehensive review of residency and source, particularly in light of globalization, the development and explosion of the trade in services and the communications revolution.

II. Findings and revelations

As there are a myriad of possible tax policy objectives against which the effectiveness of the law can be measured, the initial analysis undertaken (in Chapter 2) was to identify the most appropriate tests for evaluating the law. This involved setting out a range of possible tax policy objectives, which could be used to evaluate the adequacy of the law of residency and source, drawn from major and minor Australian inquiries and reviews, major tax reform reviews conducted in other jurisdictions, independently commissioned studies and academic writing.

3 See generally Peter Harris, *Metamorphosis of the Australasian Income Tax: 1866 to 1922* Research Study No 37, Australian Tax Research Foundation (2002).

4 Australian Taxation Office, Commonwealth, *Tax and the Internet: Discussion Report* (1997), vii.

5 *A Tax System Redesigned* (1999), above n 1, 684, Recommendation 23.2(c)(ii).

6 Board of Taxation, Commonwealth, *International Taxation: A Report to the Treasurer* (2003) 109 (Recommendation 3.12).

A series of common tax policy objectives emerges from that analysis. First, there is wide spread use in evaluating the effectiveness of existing laws and the proposed tax reforms of the three tax policy objectives of equity, simplicity and efficiency. Second, underlying a number of most recent reform reviews, the policy objective of reducing tax avoidance is also commonly used. The scope of these four tax policy objectives was examined in detail in order to define each term and set out the process for measuring the extent to which the law of residency and source complies with the objectives. This was important given the legal focus of this study as the evaluative process is qualitative in nature rather than quantitative or empirical.

In Chapters 3 to 5 the residency rules applicable to individuals, companies and trusts and the determinations of source income were evaluated against these tax policy objectives. There were three key findings.

First, in the examination of the residency and source rules it was found that overall they mostly failed in some way to satisfy the equity, efficiency, simplicity and prevention of tax avoidance evaluative criteria. The major weakness in most of the tests is the “individual fact and circumstances” element, which in certain situations:

- results in horizontal inequity;
- gives rise to the lack of simplicity; and
- leaves the rules open to manipulation.

Although the facts and circumstances element of the tests does cater for a taxpayer’s or a transaction’s particular circumstances, a determination in accordance with the “individual facts and circumstances” of a matter will not, in most cases, ensure that the law has delivered horizontal equity.

Second, another cause of the complexity is the tendency to attempt to limit the application of particular corporate tax policy rules (for example, those rules applying in respect of deemed companies and those that operate for specific tax policy purposes)⁷ by modifying the company residency definitions in s 6(1) of the 1936 Act. The result is a myriad of definitions with many of the failings identified above. In designing the

limitations in terms of current jurisdictional constraints, the policy makers have imported the weakness of the company residency definitions as well as imbedding common law concepts (such as central management and control). A similar process has occurred in respect of specialised trust residency definitions.

Finally, that the law of residency and source is archaic. The statutory residency rules were introduced in 1930, while some of the statutory source rules have their genesis in the 1936 Act, for others it is found in the 1915 Act and others in the 1890s' State and New Zealand income tax acts.⁸ Similarly the common law principles in respect of residency and source were established in the United Kingdom in the late 1890's. The fact the law has ancient origins in itself is not the issue, rather it is the ability of that law to engage in a 21st century world where trade in services outstrips trade in goods and the communications revolution has removed the need for traditional physical linkages to jurisdiction. It has been clearly shown that to respond to these environmental changes will involve recasting the jurisdictional claim and it is imperative that this process is transparent.

In the context of residency rules for individuals, the comparative study of individual residency rules found that whether a jurisdiction adopts a facts and circumstance criterion or a more objective criterion to determine residency is not dependent on the basis of the legal system (civil or common law) nor the structure of the tax codes (single code or schedular code). Although this study was not repeated in respect of company residency and source, similar trends seem evident. It appears nations set their residency rules based upon each jurisdiction's own economic and social value judgments.

The broader comparative studies in respect of residency and source also revealed that the models adopted in other jurisdictions often struggled to satisfy the tax policy objectives. However, individually, the rules operating in other jurisdictions do offer alternatives that could be adopted in any future recasting of the Australian rules. The foreign individual residency rules offer the greatest number of options, while the models of corporate residency operating in other jurisdictions are merely variants of the tests

7 Specific purpose residency rules apply in the FSI rules, the dividend imputation system, and thin capitalization.

8 For example, as mentioned above in Chapter 4, the ship charterer source rules were introduced into New South Wales in 1895 and in Victoria in 1896. The rules in NSW were adopted from the *The*

adopted in Australia. The source options are similarly limited: codification or the status quo. However, despite limitations on reform options the study did illustrate how improvements in simplicity, equity and efficiency can be achieved in both the residency and source context by merely changing the structure of some of the tests to counter the problems identified.

Finally, the thesis examined the extent to which the law could be modified, within the existing jurisdictional claim, to better meet the evaluative criteria. Outside some recommendations about gender specific language and other minor technical improvement the major recommendations were:

- in respect of individual residency tests, that the superannuation test should be repealed and the ordinary resident test removed and some minor amendments to the domicile, 183 day and resides tests;⁹
- in respect of the company residency rules, that the “voting power” test be repealed and the “central management and control” test amended to restore the “carries on business” element of the test;
- in respect of trusts, there were no recommendations, rather an observation that given the rules rely heavily on the residency rules relating to individuals and companies, it is only through the improvement in these underlying concepts that the residency rules for trusts can be improved: and
- in respect of source of income, given that the determination is generally conducted by weighing facts in accordance with legal jurisdiction principles embodied in the common law, it is difficult to modify the rules within the jurisdictional framework to better meet the evaluative criteria, except for limited codification in respect of income from employment and income from real property.

In the main, the changes recommended are minor changes. Although they result in rules that better meet the evaluative criteria, the improvement is not dramatic.

Land and Income Tax Assessment Act 1891 (NZ) Schedule C (1) – FH Salusbury and W Newberry, *Salusbury and Newberry’s Land and Income Tax Assessment Act of 1895* (1896), 86.

9 These recommendations were that the “permanent place of abode” gloss of the domicile test should be amended to restore the original intent of the test, and the 183 day test amended to clarify how

There are also two observations that can be made from the reform evaluation process. First, the less abstract the circumstance the easier it is for nations to apply legally based geographic jurisdictional rules. For example, it is generally simple to determine where a real person is physically present, but to determine where a company physically “lives” is conceptually difficult. Similarly, given that profit is merely the difference between income and expenditure, finding its existence in a physical space (ie applying fictional physical source) is conceptually difficult and artificial.¹⁰ Therefore, it is not surprising that geographically based rules of attachment, developed in the late 19th and early 20th century struggle to deliver law that is equitable, efficient, simple and prevents tax avoidance.

The second observation is that although these changes, combined with some technical alternations, will result in the rules better meeting the evaluative criteria, greater improvements can only be achieved through variations to the jurisdictional claim.

In summary, the thesis provides an exhaustive, contemporary evaluation of Australian residency and source against the evaluative criteria of equity, efficiency, simplicity and the prevention of tax avoidance. It establishes that there is little scope for dramatic improvement without a rearticulation of Australia’s jurisdictional claim (ie the “rules of engagement” with which Australia seeks to enforce its rights to tax).

III. The way ahead

As stated in Chapter 2 (Part IV A), from a policy perspective, it is preferable to undertake a fundamental evaluation of Australia's taxation jurisdictional claim, than to adopt piecemeal solutions that merely fiddle at the edges.¹¹ To ensure the success of such a fundamental evaluation of Australia's taxation jurisdictional claims, it is

the period is calculated by defining what time period constitutes a day and to specify a commencement date for residency.

10 John Prebble, ‘Fictions of Income Tax’ (2002) (Paper Presented at the 14th Australasian Tax Teachers Association Conference, Auckland, 18 January 2002) 3. Prebble notes that “[t]o cope with companies one must operate as if the fiction of corporate residence were a fact. To cope with profits, one must attribute a fictional physical source to income. That is the problem of place in a nutshell.”

11 Alice Abreu, ‘The difference between expatriates and Mrs Gregory - Citizenship can matter’ (1995) *Tax Notes International* 1613, 1615. Abreu notes “[i]t would be nice if we could stop reacting to problems in the tax system by attempting to design new and improved Band-Aids and could turn instead to a comprehensive examination of the structural features of the system that cause the problem to arise in the first place.”

necessary first to clearly articulate what is the scope of that claim, before comparing it with the existing claim. It is only with this policy articulation that simple, equitable and efficient residency and source rules can be designed. In formulating this reform policy, consideration must be given to determine who or what should be a resident and which income of non-residents we wish to tax. It is only with this articulation that the absence of taxation can be viewed as an intended result rather than the result of avoidance.

Given globalisation, the changes in the world trade and technology revolution, the case for reform has never been stronger. Ultimately, the solution lies with a new, clear articulation of Australia's jurisdictional claim ("rules of engagement") based upon robust tax policy objectives.

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